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REVIEW OF UNITARY METHOD OF TAXATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 1113 and S. 1974

SEPTEMBER 29, 1986

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REVIEW OF UNITARY METHOD OF TAXATION

MONDAY, SEPTEMBER 29, 1986

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable John H. Chafee (chairman) presiding.

Present: Senators Chafee and Baucus.

[The press release announcing the hearing and a description of S. 1113 and S. 1974 by the Joint Committee on Taxation follow:]

[Press Release]

FINANCE COMMITTEE TO REVIEW UNITARY METHOD OF TAXATION

The Senate Finance Committee today announced that the Subcommittee on Taxation and Debt Management will examine S. 1974, a bill introduced by Senator Pete Wilson (R-California) on behalf of the administration; and S. 1113, a bill introduced by Senator Charles McC. Mathias, Jr. (R-Maryland), that prohibits the imposition by States of the worldwide unitary method of taxation.

The Taxation Subcommittee will review S. 1974 and S. 1113 at a hearing set for 9:30 a.m. on Monday, September 29, 1986, in room SD-215 of the Dirksen Senate Office Building. Senator John H. Chafee (R-Rhode Island), chairman of the subcommittee will preside at the hearing.

DESCRIPTION OF S. 1113 AND S. 1974
RELATING TO
STATE TAXATION OF MULTINATIONAL BUSINESS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

on September 29, 1986

Prepared by the staff

of the

JOINT COMMITTEE ON TAXATION
September 29, 1986
JCX-27-86

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on September 29, 1986, on legislative proposals to limit State taxation of multinational business (S. 1113 and S. 1974).

Part I of the document is a summary.[1] Part II is an explanation of present law regarding State and Federal taxation of multinational corporations and State taxation of interstate business transactions. Part III provides a discussion of possible Federal limitations on State taxation of foreign source income. Part IV sets forth the principal issues involved. Part V is a description of the provisions of S. 1113, and Part VI is a description of S. 1974.

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[1] This document may be cited as follows: Joint Committee on Taxation, State Taxation of Multinational Business (JCX-27-86), September 29, 1986.

I. SUMMARY

State taxation of corporations

At present, States generally tax the income of corporations doing business within and outside the State by apportioning the income pursuant to a formula--this is commonly referred to as the unitary method. The States have adopted several different approaches to apply the unitary method to apportion the income of affiliated groups of corporations. Some States take into account the operations of foreign affiliates of the corporation doing business in the State to the extent that the foreign affiliates and the U.S. corporation are engaged in phases of a single "unitary" business. The practices of States in taxing dividend income from affiliated corporations also vary, depending in part on whether the income from which the dividend was paid was already subject to tax pursuant to apportionment. These State rules for determining the amount of income subject to tax differ in a number of respects from the methods employed by the Federal Government in determining the tax liability of multinational corporations.

Federal limitations on State taxation of corporations

Although the Constitution imposes some limitations on State apportionment methods, the States generally have considerable flexibility in determining their rules. The Congress in 1959 enacted limited legislation dealing with State jurisdiction to tax, but has not prescribed any additional rules.

Legislative proposals

S. 1113

S. 1113 (introduced by Senator Mathias) would limit the manner in which States could tax income of foreign affiliates. Under the bill, States and localities would generally be prohibited, in applying their income tax to a corporation, from taking into account the income of any related foreign corporation. The provisions of the bill would apply regardless of whether the parent corporation of the group is foreign or domestic. In addition, the bill would limit the ability of States and localities to apply an income tax to dividends received by a corporation from foreign corporations or U.S. corporations, substantially all of whose income is from foreign sources. Generally, some or all of the dividends would be exempted from State taxation in order to take into account foreign taxes paid on that income. A separate exemption is provided in the case of dividends from corporations making an election under Code section 936. The bill would be effective for taxable years beginning after

1986.

S. 1974

S. 1974 (introduced at the request of the Administration by Senators Wilson, Mathias, and Hawkins) would prohibit State use of the worldwide unitary combined reporting method. The bill would allow use of the combined reporting method for corporations within a water's edge group, consisting generally of corporations, both U.S. and foreign, with some threshold level of U.S. activity. The bill would limit State taxation of foreign source dividends (except in the case of the State of legal or commercial domicile). Further, the bill would impose reporting requirements on corporations subject to State tax, and would provide for sharing of Federal information with States. The bill would be effective for taxable years beginning after 1986.

II. PRESENT LAW

A. State Income Tax

1. Unitary method of apportionment for State taxation of corporate income

The question of State taxation of foreign source income is one aspect of the larger question of State taxation of businesses operating in more than one State. This larger question involves the problem of determining a State's jurisdiction for taxing a corporation's income and rules for apportioning and allocating that income among the States in which a corporation does business. Of the 45 States which impose a corporate income tax, all use some kind of formula to apportion business income between the various States in which a corporation operates. However, the specific formula used varies substantially from State to State.

In 1969, a group of States reacted to the possibility of Federal legislation (which would have required greater uniformity in apportionment) by adopting a multi-state tax compact, which established the Multistate Tax Commission whose duties are to establish uniform income tax regulations, auditing standards, and tax forms for member States. The Commission also established uniform rules regarding the allocation and apportionment of State corporate income. Presently, 19 States are members of the compact (the majority of the States are Midwestern and Western States). Under the compact, the regulations of the Multistate Commission are effective in all member States, but any member State can adopt overriding regulations if it chooses. Since most of these States have adopted some overriding regulations, the methods of taxing corporations still vary among States which are members of the compact. (The authority of the Multistate Tax Commission to operate as agent of the States in enforcing their corporate income tax laws was upheld by the U.S. Supreme Court in United States Steel Corp v. Multistate Tax Comm'n, 434 U.S. 452 (1978).)

Unitary method

The unitary method requires two steps for the apportionment of income to a particular State. First, the total amount of income subject to apportionment is determined. Second, the apportionable income is multiplied by a formula intended to reflect the portion of that income earned within the State. The resulting product is subject to the State's taxation.

Formula.--In determining income earned within a State, most States use some variation of a basic three-factor apportionment formula. Under this formula, the income of a business is apportioned to each State according to the average ratio of three factors: the ratio of sales, payroll, and tangible property values of the business in the State to the respective sales, payroll, and tangible property values of the total business. For example, a corporation which has one-half of the value of its tangible property, three-fourths of its payroll, and one-fourth of its sales in a particular State would take the average of these three fractions to determine the amount of income subject to tax in that State.[2]

Apportionable income.--A State's apportionment formula is applied only to that income of a corporation which is from a unitary business. In general, a corporation has a unitary business when the business activity from within the State is dependent upon, or contributes to, business activities of the same corporation outside of the State. Where the business activity in the State is unrelated to other businesses of the corporation outside of the State, so that there is no unitary business which is conducted in part within and in part outside of the State, all of the income from that business within that State is allocated to, and thus is taxed by, that State, and the income from the other businesses conducted outside the State is not allocated to, or taxed by, the State. Virtually all States include the income, and tangible property, payroll, and sales of foreign branches of domestic corporations in the income which is subject to their apportionment formula.

In general, a unitary business is considered to exist where, for example, a product is manufactured in one State and sold in another State, or where a product is partially manufactured in one State and then shipped to another State where the manufacturing is completed. The requirement to apportion income derives from the difficulty in determining how much of the total net income is attributable to the manufacturing operation and how much to the sales activity, in the first situation, and to the two manufacturing operations, in the second situation. However, such direct integration of business operations is not the sole criterion that has been used by the States to establish the existence of a unitary business. In some cases, the touchstone for establishment of a unitary business has been centralized management or centralized purchasing. A unitary business also has been held to exist where the home office used the assets of an otherwise unrelated business operation as collateral for a loan and, with respect to investment securities, where the securities were purchased from operating income.

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[2] Those States which do not follow this three-factor formula use other apportionment formulas, some based on sales only and others based on a combination of sales and property or sales and payroll or property and payroll. Even among those States which do use the three-factor formula, the manner of measuring the three items in the formula may differ. For example, in some States a sale is taken into account by the State where the sale originated (generally, the location of the seller) while in other States the sale is allocated to the State of destination (generally where the buyer is located).

In many States, not all of the income of a corporation is subject to that State's apportionment formula. For example, in some States passive income such as dividend income is allocated entirely to the State of the "commercial domicile" (generally the State of the principal business location) of the corporation and is thus excluded from the income subject to the apportionment formula.

Combined reporting

The States have adopted several different approaches to apply the unitary method to apportion income of affiliated groups of corporations (parent, subsidiary, and brother-sister corporations). Some States apportion on a corporation by corporation basis, and the income and business operations of affiliated corporations are not taken into account even where those operations are directly related to the business operations of the affiliates operating within and taxed by the State. However, most States in at least some circumstances combine (either mandatorily or at the taxpayer's election) the income and related business operations of some or all affiliated corporations which operate a unitary business. The combined income is then apportioned within and outside of the State in accordance with the combined property, payroll, and sales factors for the unitary business of the group within and outside of the State. Application of the unitary method in this manner is referred to as "combined reporting" and is analogous to the filing of a consolidated return for Federal tax purposes.

Worldwide combination.--Most States which use the combined reporting approach of applying the unitary method in the case of affiliated groups typically limit the affiliated corporations included in the combined report to the U.S. corporations within the group and, as in the case of Federal consolidated return provisions, the operations of foreign corporations are not taken into account. However, a few States include the operations of foreign affiliates in the combined report where those operations are dependent upon or contribute to the activities of the U.S. affiliates within the taxing State. This generally is referred to as the application of the unitary method on a "worldwide combination" basis. Some of these States require the inclusion of foreign affiliates involved in the unitary business as a matter of course; others include foreign affiliates only on occasion. In applying the unitary method on a worldwide combination basis, the income of foreign affiliates is treated in much the same manner as most States treat income of foreign branches of U.S. corporations.

Considerable controversy has surrounded the requirement by these States that the operations and income of foreign affiliates be included in the combined report. The proposed legislation which is the subject of the current hearings (see Parts V and VI of this document) is directed at this application by States of the unitary method on a worldwide combination basis.

2. State taxation of dividends from foreign corporations

Almost all States impose a corporate income tax on foreign source dividends in at least some situations. A few States completely exempt dividends, or at least all dividends received from foreign corporations (including deemed dividends of tax haven income taxable for Federal income tax purposes under subpart F of the Code). Some of the States which do tax dividends do not include the dividends in the income to be apportioned by the unitary method among the States. (This is particularly the case where the dividends received from a subsidiary do not arise out of earnings from business operations of the subsidiary which are related to those carried on in the State by the U.S. corporation.) These States generally allocate the dividends, and thus jurisdiction to tax, entirely to the U.S. corporation's State of commercial domicile.

In those States where the income and payroll, sales, and property factors of the foreign subsidiary are taken into account through worldwide combination in determining the income of the U.S. parent to be apportioned to the taxing State, dividends distributed by the foreign corporation out of the unitary business are not included in the income to be allocated or apportioned so as not to be taxed twice by the State. However, dividends which are not out of the unitary business income which has been taken into account in computing the U.S. corporation's apportionment formula are included in income and are taxed when distributed. In other States where dividends from a foreign subsidiary carrying on a unitary business with the U.S. parent are subject to tax, but where the foreign subsidiary's income is not subject to tax as it is earned pursuant to a combined reporting method (e.g., the Vermont system considered in the Mobil case), dividends may be included in income and apportioned in accordance with the payroll, sales, and property factors of the U.S. corporation (which would allocate to the State a higher portion of the income being apportioned since the foreign factors are not taken into account). The rationale for apportioning such a dividend is that the income from which the dividend is paid was not previously subject to tax.

3. Comparison with Federal taxation of multinational corporations

In general

For Federal income tax purposes, U.S. corporations (those incorporated in the United States) are taxable on their worldwide income--both from sources within and outside of the United States. The United States does, however, cede primary tax jurisdiction on foreign source income to foreign governments by the allowance of a credit for the foreign income taxes paid on foreign source income. (The foreign tax credit is limited to the precredit U.S. tax attributable to foreign source income). The foreign tax credit is allowed for foreign income taxes imposed by provinces, cities, and other political subdivisions as well as those imposed by national governments.

The Federal rules applicable to foreign corporations (those incorporated outside the United States) are more directly analogous to the State rules previously discussed--foreign corporations generally are subject to Federal income tax only on their U.S. source income. This generally is true even in the case of foreign subsidiaries of a U.S. corporation--their foreign income is not taxable by the United States directly. However, if and when the income earned by a foreign subsidiary is distributed (or deemed distributed) as a dividend, the dividend is taxable to its U.S. shareholders. U.S. corporate shareholders with at least a 10-percent ownership interest in the foreign corporation are allowed an indirect foreign tax credit for their portion of the foreign taxes paid by the subsidiary which are attributable to the dividend.

The Federal rules do not follow the approach generally used by the States of aggregating all the income of a business and then apportioning it in accordance with a single formula to determine taxable income from sources within the State. Instead, as outlined below, the Federal system attempts to determine taxable income on an item-by-item basis.

Section 482

U.S. corporations are fully taxable by the United States on their worldwide income while their foreign affiliates (either foreign subsidiaries in the case of a U.S. multinational or foreign parent and affiliates in the case of foreign multinationals) are generally taxable only on their U.S. source income. Thus, there is an incentive for U.S. corporations to divert income to their foreign affiliates by distorting intercompany transfer prices. To limit this potential, Internal Revenue Code section 482 authorizes the

Internal Revenue Service to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities if the IRS determines that it is necessary in order to prevent evasion of taxes or clearly to reflect income.

In 1966, regulations were issued interpreting section 482 which generally provide that in any transaction among members of a controlled group of corporations, the affiliate receiving a benefit from a related corporation must make adequate reimbursement for the benefit. The regulations provide detailed standards for determining whether the intercompany pricing arrangements are adequate--the rules cover the pricing of sales of tangible property by one member of a controlled group to another, the use by one affiliate of the intangible property (patents, copyrights, trademarks, know-how, etc.) owned by another, intercompany loans, services provided by one affiliate to another, and other intercompany transactions. The rules generally apply an arm's-length standard--that is, they generally require that the intercompany pricing be the same as the prices which would be charged between two unrelated companies.[3]

This arm's-length standard is essentially the same standard used by other countries to govern the intercompany pricing arrangements of multinational corporate groups operating within their jurisdiction. This method also is used by those States which do not include foreign affiliates in the combined report. Since these States generally apportion (and thus tax) only the income of the U.S. members of the group, it is important that the income of the U.S. affiliates is not artificially diverted to non-taxed foreign affiliates. As a practical matter, these states rely on the Internal Revenue Service to police the intercompany pricing of multinationals. This method contrasts with the combined reporting methods used by many states, under which intercompany pricing is not relevant because the income and deductions of the affiliated companies are combined and apportioned pursuant to a formula. In much the same way, intercompany pricing generally is not important for federal tax purposes in the case of transactions between U.S. corporations included in a consolidated return.

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[3] The House-passed version of the Revenue Act of 1962 contained an amendment to sec. 482 which provided special rules for allocating taxable income arising from sales of tangible property within a related group which includes foreign corporations. The allocation was to be made by taking into consideration that portion of the payroll, property, expenses, and other factors of the group attributable to the United States. Although this method is somewhat analogous to the application of the unitary method on a combined reporting basis, it was to be applied only with respect to income from intercompany sales rather than with respect to the entire operations of the group. The provision was deleted from the bill as finally enacted because the conferees agreed that Treasury had the authority to prescribe under section 482 rules which would accomplish that objective, and Treasury was directed to explore the possibility of promulgating regulations which would do so. As noted above, the regulations promulgated in response to this direction generally adopted a different approach.

Allocation and apportionment of income and deductions

The rules for determining whether the income of a taxpayer is from sources within or outside of the United States are set forth in Code sections 861 through 864. As indicated above, the source of taxable income is important in the case of a U.S. corporation because its foreign tax credit is limited to its pre-credit U.S. tax allocable to its foreign source income, and it is important in the case of a foreign corporation because its U.S. tax is based on its income from U.S. sources.

These rules operate by first specifying a particular source for the various items of gross income earned by the taxpayer (interest and dividends received from U.S. corporations generally are treated as U.S. source income; income from the performance of services generally is sourced where the services are performed, etc.). After the source of the various items of gross income has been determined, taxable income from sources within and outside of the United States is determined by deducting from each the expenses, losses, and other deductions properly apportioned or allocated to each, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income (Code secs. 861(b) and 862(b)).

The regulations (Treas. Reg. sec. 1.861-8) set forth detailed rules for the allocation and apportionment of deductions to U.S. and foreign source gross income. These rules provide in certain circumstances for the apportionment of deductions of a U.S. corporation on the basis of assets or sales of all corporations within the controlled group, including the foreign subsidiaries. The Tax Reform Act of 1986 (H.R. 3838) would, if enacted, require a U.S. affiliated group to apportion interest expense and certain other expenses as if the U.S. group were one corporation.

B. Worldwide Unitary Taxation Working Group

In response to concerns expressed by the U.S. business community and major U.S. trading partners in connection with worldwide unitary combination, the Administration organized a Cabinet Council on Economic Affairs (CCEA) Working Group in July, 1983, to develop possible options and recommendations on this issue. The CCEA Working Group was composed of members of various Federal departments and agencies. The working group issued a series of options to President Reagan in September 1983, one option of which was its recommendation to establish a working group which would include representatives of the business community, Federal Government, and State governments to study the issue further and attempt to achieve coordinated solutions to the problems created by the worldwide unitary method of taxation.

The Worldwide Unitary Taxation Working Group held several meetings from its establishment in September 1983 through May 1984. The working group was unable to reach a consensus on some issues, but it did establish a set of principles that were intended to guide States in developing legislation subjecting multinational corporations to State income tax. The three principles on which the working group reached a consensus are: (1) provide water's edge limitation on unitary combination for both U.S. and foreign companies; (2) increase Federal administrative assistance and cooperation to assure full disclosure and accountability of taxpayers; and (3) balance the competitiveness of U.S. multinationals, foreign multinationals, and purely domestic businesses.

In August 1984, the Secretary of the Treasury submitted a report to President Reagan containing the three principles agreed to by the working group, plus an explicit statement of disagreement on two issues. The report indicated that the three principles, other than the Federal assistance principle, should be implemented on a State-by-State basis, rather than by Federal legislation. The two issues on which the working group was not able to achieve a consensus were the proper tax treatment of foreign source dividends by the States, and whether domestic corporations with predominantly foreign operations (commonly referred to as "80/20 companies") should be includible in a unitary group. The report indicated that those issues were to be resolved by each State, taking into account the competitive balance principle proposed by the group. Finally, the report indicated that the Treasury Department would recommend to the President that the Administration propose Federal legislation that would require a water's edge limitation to the unitary method if the States did not show sufficient progress by July 1985 in incorporating in legislative or administrative action the principles set forth by the working group.

On July 8, 1985, the Treasury Department released proposed legislative language designed to implement the recommendations of the Working Group. Although parts of that July 1985 proposal are incorporated in S. 1974, described in

Part VI, below, S. 1974 differs substantively from that proposal.

C. Recent State Legislative Action

When the Worldwide Unitary Taxation Working Group was established, 12 States based their unitary method on some form of worldwide combined reporting.[4] At the present time, all but three of these States, Alaska, Montana, and North Dakota, have stopped requiring worldwide combined reporting.

California, the State with the longest experience in worldwide combined reporting, is the most recent State to modify its worldwide unitary method. California legislation (SB 85), enacted September 5, 1986, allows corporations to continue computing their State tax liability under either the present law worldwide unitary method or under a new "water's-edge" unitary method. Thus, corporations with a unitary business in California can either continue to include all affiliated corporations in the combined group or only those corporations considered to be within the water's edge. The legislation treats the following corporations as within the water's edge: (1) any corporation eligible to be included in a Federal consolidated return; (2) Domestic International Sales Corporations and Foreign Sales Corporations (as defined in Internal Revenue Code secs. 992(a) and 922, respectively); (3) any corporation that has an average three-factor formula (sales, property, and compensation) percentage of 20 percent or more assignable to a location in the United States; (4) any U.S. corporation other than a possessions corporation if more than 50 percent of the stock is commonly controlled; (5) any other corporation, but only to the extent of its income derived from, or attributable to, U.S. sources and factors assignable to U.S. locations, as computed under a separate accounting; (6) Export Trade Corporations (as defined in sec. 971(a)); and (7) controlled foreign corporations (as defined in sec. 957) but only to the extent of such corporations' subpart F income (as defined in sec. 952). In addition, U.S. branches of foreign banks are treated as separate corporations. Corporations that elect the water's edge unitary method are subject to a fee of .03 percent of their sales, property, and payroll assignable to California. The election also requires that corporations submit to certain reporting requirements. Other provisions of the legislation include a provision equivalent to IRC section 482, a 75 percent exclusion for certain foreign dividends in computing apportionable income, and limits on the installment method of accounting and reserve method for computing bad debts.

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[4] These States are Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon, and Utah.

III. FEDERAL LIMITATIONS ON STATE TAXATION OF FOREIGN SOURCE INCOME

A. Constitutional Limitations

A number of recent Supreme Court cases are particularly relevant to constitutional limitations on State income taxation.

Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978)

Moorman dealt with the application of the unitary method in connection with interstate, rather than foreign, commerce, but it would appear to be of general application. The case sustained Iowa's single-factor sales formula for apportioning income against a constitutional challenge. The Court first held that there had been no violation of the Due Process Clause. The Court rejected Moorman's argument that it was unconstitutionally taxed on the same income by both Iowa and Illinois because Moorman could not prove, under a separate accounting analysis, that Iowa taxed its out-of-State income. The Court held that it was not necessary for a State's apportionment formula to result in tax on no more than the exact amount of income earned in the State. Generally, a State tax would be upheld so long as there was at least a minimal connection between the activities being taxed and the values of the enterprise there. A single-factor formula would presumptively meet the second test, unless there were clear evidence in a particular case that the results were grossly distorted. The Court ruled that Moorman had made no such factual showing.

The Court also held that, in the absence of an actual showing of double taxation, it would not find that Iowa's formula violated the Commerce Clause. The Court declined to hold that the formula must be invalidated if there were a mere possibility of double taxation, pointing out that this would require the Court to prescribe in detail a single uniform allocation formula by which all the States would be bound. The Court did indicate, however, that the legislative power granted to the Congress under the Commerce Clause would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.

Japan Lines, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)

In this case, the Court considered whether or not a California property tax imposed an unconstitutional burden in cases where the tax was imposed on ships' cargo containers which were utilized exclusively in foreign commerce. The containers were owned, based and registered abroad. In finding that the tax was unconstitutional, the Court held that it was not enough that the tax meet the requirements applicable to State taxation of instrumentalities of interstate commerce: that the tax be on an activity with a substantial nexus to the taxing State, be fairly apportioned, be nondiscriminatory, and be fairly related to services provided by the State. Rather, the Court observed that there were two additional considerations where instrumentalities of foreign commerce were involved. First, multiple taxation was a greater possibility because no one tribunal was available to reconcile the claims of the competing taxing jurisdictions. Second, the State tax might prevent the United States from speaking with one voice when regulating commercial relations with foreign governments. The Court held that California tax failed both of these tests.

Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980)

Under the Vermont tax system, foreign source dividends received by a U.S. corporation doing business in Vermont are included in the income subject to apportionment pursuant to Vermont's three-factor formula and the amount apportioned to Vermont is subject to its corporate income tax. Mobil challenged taxation by Vermont of the foreign source dividend income received by Mobil from its affiliates. (These were generally foreign corporations, although dividends from Aramco, a U.S. corporation operating in Saudi Arabia, were also involved.) Mobil argued that the dividend income should instead be allocated in its entirety to New York, the State of its corporate domicile. (Under New York law, however, the foreign dividend income would be exempt from State tax.)

The Court first held (citing Moorman) that the Vermont tax did not violate the Due Process Clause of the Constitution because there was at least a minimal connection between Mobil's activities and Vermont and because there was a rational relationship between the income attributed to Vermont and the activities in Vermont. These criteria were met with respect to the apportioned dividend income because it represented the earnings of Mobil's unitary petroleum business. In this regard, the Court looked to the underlying activities of the subsidiaries.

The Court also held that the Vermont tax did not violate the Interstate Commerce Clause of the Constitution because the four criteria for State taxation (outlined above in the discussion of Japan Lines) had been met. Mobil failed to show that Vermont's apportionment resulted in double taxation because New York did not tax the dividends. In the absence of actual multiple taxation, the Court found no reason to require Vermont to switch from its apportionment method to a method which would allocate the dividends entirely to New York.

Further, the Court found no violation of the Foreign Commerce clause. Mobil took the position that the dividends should be taxable only in the jurisdiction of domicile, on an analogy to *Japan Lines*, in which the Court had held that the containers *should only* be taxable in Japan. The Court observed, however, that Mobil's case did not involve international double taxation; rather, Mobil was arguing that double taxation might occur as among the states. However, such double taxation would be within the power of the Court to remedy, so the special considerations of *Japan Lines* on this point were not applicable. The Court *further declined* to hold that considerations of Federal tax policy required Vermont not to tax the dividend income, in the absence of an explicit directive from the Congress.

Mobil argued in its reply brief that, if its dividends from its affiliates were to be included by Vermont in income subject to apportionment, then the property, payroll and sales of those affiliates should be taken into account in determining the amount of income apportionable to Vermont. (This method would be similar to the combined reporting method then in effect in California.) The effect of including the property, payroll and sales of the affiliates in the apportionment fraction would have been to reduce the income apportionable to Vermont, because the activities of these affiliates were outside the state. However, the Court held, on procedural grounds, that Mobil had waived its right to advance this argument. Accordingly, the Court made no decision as to whether this combined reporting would be constitutionally required. This holding as to the procedural posture of the case was in large part the basis of dissent by Justice Stevens, who argued that consideration of the property, payroll, and sales of affiliates in the apportionment fraction would be required if Vermont sought to tax Mobil's dividend income from those affiliates.

Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980)

Relying heavily on the *Mobil* case, the Supreme Court held that Exxon's three separate functional departments (exploration and development, refining, and marketing) constituted a unitary business whose income was subject to apportionment under Wisconsin law. Exxon had argued that since its functional departments were separate profit centers that had separate accounting and made intercorporate transfers at market wholesale prices, and since only its marketing function had contact with Wisconsin, its tax liability to Wisconsin should be based upon the separate accounting income of the marketing function (which incurred a loss for the four years at issue).

The Court held that the application of Wisconsin's appointment formula to the income of Exxon's entire group of functional departments did not violate the Due Process Clause of the Constitution, which required that there be a minimum nexus between Exxon's activities and the State of Wisconsin, and that there be a rational relationship between the income attributed to Wisconsin and the intrastate values of Exxon within the State. The first requirement was met by virtue of Exxon's marketing activities within the state. However, Exxon argued that its separate accounting established that the tax imposed under Wisconsin's apportionment formula was out of all proportion to Exxon's business activities within the State and, therefore, Wisconsin's apportionment formula did not satisfy the second Due Process requirement.

The Court responded to Exxon's argument generally by stating that separate accounting as a measure of an enterprise's true income from within a State was not constitutionally required because it may fail to account for contributions to income from such things as centralized management and economies of scale. The Court held that in the case of a unitary business, apportionment is the appropriate method of measuring the income that is reasonably related to the activities conducted within the State. The Court further held that in order to be excluded from the apportionment formula, income must be earned in activities unrelated to the activities carried on within the taxing State. In making this determination the Court would look "to the 'underlying economic realities of a unitary business' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise.'"

Exxon made a second Due Process argument that its income from the sale of crude oil and gas at the wellhead should be allocated to the situs State rather than be subject to apportionment. Wisconsin agreed to the extent the oil and gas were sold to third parties. Therefore, the only issue before the Court was the treatment of intercorporate sales of crude oil and gas within Exxon itself. The Court held that this activity was part of the unitary business and, accordingly, the income should be included in the apportionment formula. (The Court specifically stated that it was not addressing the issue of whether the Due Process Clause would require that the income from the third party sales of crude oil and gas be allocated to the situs State rather than apportioned.)

Further, the Court rejected Exxon's argument that the Interstate Commerce Clause requires that Exxon's income from exploration and production of oil and gas be allocated to the situs state. Essentially, the Court held that those qualities that make Exxon's activities a unitary business also satisfy the requirements of the Commerce Clause that the tax (1) be applied to an activity with a substantial nexus with the taxing State, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the State.

Container Corp. of America v. *Franchise Tax Board, U.S. 103 S. Ct. 2933 (1983)*

In the case of a "unitary" business, the California tax system applies a three-factor formula (property, payroll, and sales) on a worldwide basis to determine the portion of the worldwide income of a multinational enterprise that that State subjects to tax. (California has repealed the requirement that multinational enterprises use this method, but only for taxable years beginning after 1987 (see discussion below).) The Supreme Court held that that California system, as applied to a multinational enterprise headed by a domestic corporation, was not so inaccurate as to violate the constitutional requirement of fair apportionment under the Due Process and Commerce Clauses. The Court found that the three-factor formula necessarily was imperfect, but it found no evidence that the margin of error in that three-factor formula was greater than that inherent in section 482-style separate accounting (the alternative that the taxpayer contended was constitutionally mandated). In addition, the Court found that, under the Foreign Commerce Clause, the three-factor formula did not improperly impair Federal uniformity and was not pre-empted by Federal law then in effect. The Court did not address the application of the California system to foreign-based multinational enterprises.

B. Prior Congressional Action

In response to U.S. Supreme Court decisions in the late 1950's upholding the power of States to tax income from interstate commerce, Congress enacted Public Law 86-272 (15 U.S.C. secs. 381-384). That law provides that, in general, no State or locality may impose an income tax on any person engaged in interstate commerce if the only activities of the person in the State are the solicitation of orders for tangible personal property which are sent outside the State for acceptance and are filled by shipment from outside the State. For this purpose, a person is not treated as engaged in a business within the State merely by reason of the sales activities of independent contractors.

Subsequently, a number of bills were introduced which would have mandated greater uniformity in the rules for State taxation of corporations. Two of these bills passed the House of Representatives,[5] but no further action was taken.

C. Recommendations of 1977 Ways and Means Task Force on Foreign Source Income

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[5] H.R. 2158 (90th Cong.) and H.R. 7906 (91st Cong.).

The Ways and Means Committee, in the Tax Reform Act of 1976, agreed to a number of major changes which would have produced significant revisions in the taxation of foreign source income. In addition, there were several other proposed changes in the taxation of foreign source income which were considered by the committee but which the committee decided needed further study. Therefore, the committee established a task force to analyze the issues involved and to recommend to the full committee any appropriate legislative changes.[6] The proposals referred to the task force included proposals to limit the manner in which States could take into account the operations of foreign affiliates of U.S. corporations.

The task force made the following recommendations with respect to State taxation of foreign source income:

(1) Income of foreign affiliates not subject to Federal income tax.--It was recommended that the States be precluded from taking into account, under the unitary method or any other method, the income of foreign affiliates of corporations doing business within the States until such time as that income was subject to Federal income tax. (The provisions of S. 1113 and S. 1974 prohibiting the application of the unitary method on a worldwide combination basis generally follow this recommendation, with further limitations on taxation of foreign source dividends. See Parts V. and VI. below.)

(2) Income of foreign affiliates subject to Federal income tax.--It was recommended that no limitation be placed on the power of States to apply the three-factor formula on a domestic basis, under the unitary method or otherwise, to income of foreign affiliates which had been excluded under paragraph (1) above if and when such income became subject to Federal income tax.

D. Treaties

U.S.-U.K. Treaty

As originally negotiated, Article 9(4) of the tax treaty between the United States and the United Kingdom would have prevented the Federal Government and the States from extending the unitary method on a worldwide combination basis to related foreign enterprises where the enterprise doing business in the State was either a British enterprise or a

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[6] The task force was comprised of 10 members of the Ways and Means Committee, with Mr. Rostenkowski as chairman. It submitted its report on March 8, 1977.

U.S. corporation controlled directly or indirectly by a British enterprise. Thus, for example, if a U.S. branch of a British corporation did business in a State, that State could not apply the unitary method to combine the income (and sales, payroll, and property) of any related foreign enterprises (from the United Kingdom or any third country) with those of that British corporation in determining the income of its U.S. branch which is taxable by that State. Alternatively, if the British corporation did not do business in the State, but had a U.S. subsidiary doing business in the State, that State, in determining the taxable income of that U.S. subsidiary, could not apply combined reporting requirements to include the income (and the sales, payroll, and property factors) of the British parent corporation or other related foreign enterprises.

When the treaty was first considered by the U.S. Senate, Senator Church proposed a reservation which would have had the effect of deleting from the treaty this provision as applied to the States. The reservation lost on the Senate floor by a vote of 34 yeas, 44 nays. However, the Senate thereafter, by a vote of 49 yeas, 32 nays, failed to concur in the proposed treaty containing the State taxation provision by the required two-thirds vote (ratification would have required an affirmative vote of 54 of the 81 Senators voting). After the Treasury Department announced that it would accept the treaty with a reservation deleting the limitation on the States, the Senate reconsidered the treaty and gave its advice and consent to ratification of the treaty, subject to the Church reservation, by a vote of 82 yeas, 5 nays. The reservation was subsequently incorporated in a protocol to the treaty, which was approved by the Senate on a unanimous vote of 98 yeas. In its report on the protocol, the Senate Foreign Relations Committeee urged the tax-writing committees of the Congress to hold hearings on the issues presented by Article 9(4) of the U.K. treaty.[7]

On July 10, 1985, the British House of Commons approved a measure that eventually would, on implementation, allow the United Kingdom to deny tax credits to U.S. corporations that have both U.K. subsidiaries and ties to one of the unitary States of the Union.

U.S.-France treaty

The question of combined reporting requirements of U.S.

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[7] U.S. Exec. Rep. No. 96-5, 96th Cong., 1st Sess. 6 (1979). The House Committee on Ways and Means held a public hearing on the subject (H.R. 5076) on March 31, 1980. The Senate Foreign Relations public committee held a hearing on the subject on September 20, 1984.

States also was discussed in an exchange of notes accompanying a recent protocol to the tax treaty with France. France took the position that for a French multinational corporation with many subsidiaries in different countries to have to submit its books and records for all of these corporations to a State of the United States, in English, imposes a costly burden. However, no provision regarding this issue was incorporated into the protocol.

Other treaties

Income tax treaties which the United States has entered into with other countries generally contain "nondiscrimination" clauses which prohibit both the Federal Government and the States from imposing on foreign taxpayers heavier tax burdens than are imposed on similarly situated domestic taxpayers. Limitations on State taxation also have been included in a number of Friendship, Commerce, and Navigation treaties of the United States. Of particular relevance here is the commercial treaty with France signed November 25, 1959 (TIAS 4625, 11 UST 2398), which provides in part that companies of either country engaged in the business in the other would not be subject to any form of taxation upon capital, income, profits, or any other basis, except by reason of their operations in that country or any other bases of taxation directly related to their activities within that country. This provision applies to political subdivisions such as the States as well as to the two national governments. Certain foreign-based multinational corporations and certain foreign governments take the position that provisions such as this prohibit the application of the unitary method on a worldwide combination basis in the case of foreign-based multinational covered by the provisions.

IV. ISSUES

Overview

Unlike the Federal Government, States generally tax corporate income according to its source rather than the residence or domicile of the corporate entity (exceptions are made for certain passive income). Source-based taxation requires that income arising within the State be separated from income arising outside of the State. States that impose a corporate income tax generally rely on formula apportionment to allocate domestic income of multistate enterprises among the States. By contrast, for purposes of separating domestic from foreign source income, most States rely on separate accounting rather than formula apportionment. One issue before the Congress is whether the three States that continue to use formula apportionment on a worldwide basis should be required to use separate accounting principles. A second issue is whether and to what extent the States should be permitted to tax foreign source dividends received by State-domiciled corporations. A third issue is the appropriate balance between the States' right to tax and the conduct of foreign policy.

Formula Apportionment vs. Separate Accounting

In general

Under separate accounting, a corporation (or a related group of corporations) is required to treat in-state and out-of-state operations as separate unrelated firms. Movements of goods or intangibles between an in-state and an out-of-state affiliate are treated as sales or licenses and must be recorded at arm's-length prices. Similarly, out-of-state affiliates must bear an appropriate share of centralized management and other overhead costs, determined on an arm's-length basis.

Under Federal tax principles, arm's-length prices are measured by reference to comparable transactions between unrelated parties where such comparable uncontrolled prices ("CUPs") can be found. In practice, many products, or the terms and conditions of their sale, are unique and no CUP can be identified. Intangibles such as patents, copyrights, trademarks, goodwill, and know-how present difficult pricing problems. Moreover, the portion of overhead costs such as central office expense, research, and interest expense that would be borne by in-state and out-of-state affiliates acting as unrelated parties cannot be determined unambiguously.[8]

By adopting formula apportionment of domestic income, the States have sought to avoid conflict among themselves and with taxpayers with respect to the determination of arm's-length prices. Under domestic formula apportionment, the combined domestic income of the in-state and out-of-state affiliates comprising a unitary business need not be accounted for separately on a State-by-State basis. Instead, combined unitary income (other than items that are specifically allocated) is apportioned between States according to objective factors such as property, payroll, and sales within each State.

While formula apportionment has achieved widespread acceptance for purposes of domestic apportionment, considerable controversy has arisen over its use by certain States for separating domestic and foreign source income of multinational corporations. Critics of "worldwide combination" contend that it (1) apportions too much income to domestic source and as a consequence results in double taxation relative to separate accounting, and (2) imposes substantial administrative costs.

Double taxation

Worldwide combination apportions more income to U.S. source than separate accounting if the ratio of profit (measured on a separate accounting basis) to apportionment factors is higher abroad than in the United States. This can occur, for example, if inputs such as property and payroll are cheaper abroad, or if management systematically requires higher profit ratios from offshore operations to compensate for greater risks.

A Treasury study using taxpayer information for the 1980 tax year estimated that on a national basis, domestic source income under worldwide combination would be 11.7 percent greater than under separate accounting.[9] Only in the finance, insurance and real estate industry group did Treasury find that worldwide combination would apportion less income to domestic source than separate accounting. Another study using Commerce Department data for 1977 found that domestic source income under worldwide combination would be 13.5 percent greater than separate accounting.[10] This study, however, found greater interindustry variation and concluded that excluding petroleum and coal producers, "... 1977 taxable income of U.S.-based multinationals would have been 2.4 percent lower under the worldwide combination regime."

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[8] Robert Tannenwald states that, "Even when reported transfer prices are reasonable or comparable market prices are easily identifiable, separate accounting often fails because it attempts to separate the inseparable. For example, the very fact that an enterprise is vertically integrated reduces its costs, so that its profits are significantly greater than the sum of the profits its components would earn if they were unaffiliated." See "The Pros and Cons of Worldwide Unitary Taxation," Tax Notes (November 12, 1984) p. 650. (Reprinted from the New England Economic Review.)

The empirical evidence described above supports the contention that worldwide combination overstates domestic source income in aggregate; however, the opposite result may occur for particular companies and industries. If worldwide combination results in overtaxation, separate accounting is one possible remedy. Alternatively, the States that use worldwide combination could modify their apportionment formulas to reduce U.S. apportionment without abandoning the principle of worldwide combined accounting.

Even if worldwide combination results in greater domestic source income than separate accounting, U.S.-based multinationals are not disadvantaged relative to foreign-based multinationals with respect to U.S. operations as long as the foreign parents of domestic companies are included in the worldwide combined report.

Administrative burden

Critics of worldwide combination contend that it imposes a heavy compliance burden on multinational corporations. For example, the New York State Bar Association Tax Section identifies the following compliance issues: "... (1) the need to translate foreign currencies into United States currency; (2) the unavailability of information needed to construct the apportionment formula; (3) laws of foreign countries often prevent the disclosure of information needed to construct the apportionment formula; and (4) different accounting systems

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[9] U.S. Dept. of the Treasury, Office of Tax Analysis, "Comparison of Various Options on the Treatment of Dividends," unpublished paper prepared for the use of the Task Force of the Worldwide Unitary Taxation Working Group. The study is limited to U.S. multinationals and their controlled foreign corporations and excludes payroll factors. (Text shows domestic base under separate accounting as 89.5 percent of worldwide combination which implies that the domestic base under worldwide combination is 111.7 percent (1/.895) of the separate accounting base.)

[10] Tannenwald, Robert. op. cit.

in use in different countries must be conformed to a United States tax accounting system."[11]

Proponents of worldwide combination have noted that a domestic-based multinational is required for Federal tax purposes to provide most of the information that is required for purposes of worldwide combined accounting, since the Federal Government taxes income derived by U.S. corporation on a worldwide basis and requires certain foreign subsidiaries to file information returns with their U.S. shareholder that contain information similar to that required by worldwide unitary reporting. Thus, the additional administrative burden imposed by the worldwide unitary method is primarily attributable to foreign-based multinationals.

In addition, proponents observe that the separate accounting principles in the Internal Revenue Code cause significant administrative burden and uncertainty. A General Accounting Office ("GAO") study of the Federal taxation of multinationals found,[12]

> "Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. A constructed price is at best an estimate. Because Treasury regulations do not provide sufficient guidance, corporate taxpayers lack reasonable assurance concerning how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers."

Moreover, the separate accounting method in the Code relies on formula apportionment to determine the source of certain expenses (sec. 861 and Treas. Reg. sec. 1.882-5). General and administrative expenses (G&A) and research expenses are apportioned between U.S. and foreign source on the basis of income or sales, and interest is apportioned on the basis of income or assets. (Under the Tax Refom Act of

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[11] New York State Bar Association Tax Section, Committee on Interstate Commerce, "Report on Legislation Prohibiting State Taxation on a Worldwide Unitary Basis," Tax Notes (August, 25, 1986) pp. 817-824. Quoted material appears on page 821.

[12] U.S. GAO, IRS Could Better Protect U.S. Tax Interest in Determining the Income of Multinational Corporations, GGD-81 (September 30, 1981) p. v.

1986, H.R. 3838, interest may be apportioned only on the basis of assets.) In the case of possessions corporations, income from intangibles may be apportioned between U.S. and foreign source using one of two elective formulary methods (sec. 936(h)). Thus proponents of worldwide combination argue that the Federal tax system uses a mixture of separate accounting and formula apportionment to determine the source of income.

In addition, proponents of worldwide combination argue that the State burden of administration could be increased if the States are required to use separate accounting since the States would have to apply rules similar to IRC section 482, and information from related party transactions is not available to the States (e.g., exchange of information agreements generally do not include States, and confidentiality of Federal information does not allow access by States).

Critics respond that even if it is conceded that separate accounting under Federal principles is not inherently less burdensome than worldwide combination, since U.S. companies must compute Federal tax liability in any event, the States should not impose an additional compliance burdens on taxpayers by requiring the use of an entirely different method for sourcing income on State tax returns. However, many States do not follow Federal tax rules with respect to the taxation of wholly domestic firms. For example, depreciation methods permitted by the States are often less accelerated than the accelerated cost recovery system enacted in 1981. Thus, the burden on taxpayers resulting from differences in Federal and State tax rules may not be sufficient reason to impose Federal restrictions on the unitary method.

80/20 companies

For Federal tax purposes, 80/20 corporations are U.S. corporations which derive at least 80 percent of income from foreign sources as measured by Federal source rules. By contrast, the 80/20 corporations referred to in the options developed by the Worldwide Unitary Taxation Working Group are U.S. corporations with at least 80 percent of property and payroll outside of the United States. The July 1984 report of the Worldwide Unitary Taxation Working Group expressed a consensus among participants that separate accounting should be adopted by the States. However, participants disagreed about the appropriate treatment of 80/20 companies under separate accounting principles.

The arguments for and against worldwide combination generally apply with equal force to the question of whether 80/20 companies should be included in the combined taxable income of a unitary business. A number of States that generally support the use of Federal tax principles for separating domestic and foreign source income (i.e., the water's-edge principle), nevertheless wish to reserve the right to apportion the income of 80/20 companies. Critics of worldwide combination believe that Federal tax principles should be followed consistently.

Taxation of Foreign Source Dividends

While only three States currently employ worldwide combination, 27 States tax to some extent foreign source dividends.[13] Thus, many more States would be affected by a Federal limitation on the right of States to tax foreign source dividends than by a limitation on worldwide combination.

State taxation of foreign source dividends is a notable exception from the general principle of taxing income according to its source. The taxation of foreign source dividends varies significantly from State to State. Some States allocate while others apportion dividends. In either case, the inclusion of foreign source dividends in the State income tax base may result in multiple corporate-level taxation of the income giving rise to the dividend. This may occur because foreign source dividends are paid out of income which may be subject to foreign income tax, and the dividend itself may be subject to foreign withholding tax at the time of repatriation. Unlike the Federal Government, the States do not provide a tax credit for foreign taxes deemed paid with respect to foreign source dividends to prevent double corporate-level taxation.

State taxation of foreign source dividends has been criticized on the grounds that it can result in a higher tax burden being imposed on U.S.-based relative to foreign-based multinationals. To the extent that this occurs, U.S.-based multinationals arguably are at a competitive disadvantage compared to foreign multinationals.

Proponents of State taxation of foreign source income argue that (1) there is no constitutional prohibition against such taxation, (2) companies are free to switch State domicile to avoid such tax, (3) restricting the State right to tax foreign source income will result in higher taxes on domestic corporations, and (4) State practices do not harm national interests.

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[13] Statement of John D. LaFaver, Chairman, Multistate Tax Commission, before the Subcommittee on Taxation and Debt Management, U.S. Senate Committee on Finance, September 29, 1986.

Proponents also contend that State tax rules allow deductions for costs such as G&A, research, and interest which generate income from foreign subsidiaries. Consequently, inclusion of foreign source dividends in the State tax base is necessary to match income and expense. Critics of the State view argue that Federal tax principles require apportionment of certain U.S.-incurred overhead expenses to foreign sources, and that the States can achieve matching of income and expense without including foreign source dividends by following Federal source principles.

S. 1113 and S. 1974 would require partial or, in some cases, complete exclusion of intercorporate foreign source dividends from State taxation. These bills appear to strike a compromise between allowing States to tax fully foreign source dividends and requiring that such dividends be excluded from State taxation. Critics contend that no tax policy principles justify the arbitrary formulas for determining the exclusion percentages in these bills.

Foreign Policy Considerations

A number of the nation's leading trading partners have expressed substantial concern about the use by certain States of worldwide combined reporting. In addition, threats of retaliation have been made. In part as a response to foreign policy considerations, the Worldwide Unitary Taxation Working Group was established in 1983 under the President's directive. Following the report of the Working Group in July of 1984, some States have repealed worldwide combination, most notably California. However, retention of worldwide combination by three States may be a source of continuing international friction that could adversely affect trade and treaty negotiations.

By contrast, foreign governments do not appear to be very concerned about the U.S. tax treatment of foreign source dividends, presumably because such taxes fall primarily on U.S.-based rather than foreign-based multinationals. Thus, the imposition of Federal limitations on State taxation of foreign source dividends is unlikely to have any significant effect on the conduct of U.S. international economic policy.

V. DESCRIPTION OF S. 1113
(Senator Mathias)

A. Prohibition of Worldwide Combination

The first part of S. 1113 generally would prohibit the States (or their political subdivisions) from taking into account, through the application of a worldwide unitary combination method or by any other method, the income of foreign affiliates of corporations doing business within the States and unless that income is subject to Federal income tax. The corporation doing business within, and subject to tax by, the State generally would be a corporation organized under U.S. law, but it also could be a foreign corporation operating through a U.S. branch. In the following discussion of S. 1113, the term "taxable corporation" is used to refer, in either case, to the corporation doing business in the State.

As an exception to this general rule, the State or locality may include in the income of a U.S. corporation any income of a foreign corporation which is includible in the U.S. corporation's income for Federal purposes under the income tax provisions of the Code. For example, tax haven income of a controlled foreign corporation which under subpart F (Code secs. 951-964) is includible in the U.S. corporation's income for Federal tax purposes[14] also could be taxed at the State or local level (subject, however, to the bill's special rules regarding dividend income discussed in the following section).

The legislative proposal thus would prohibit, for example, the use of the worldwide combination method of reporting. Under that method, the income of foreign affiliates of a corporation subject to tax in a State is included in total income subject to apportionment if the activities of the two corporations are part of a unitary business. (The property, payroll, and sales of foreign corporations frequently are taken into account also in determining the amount of income apportionable to a State using the worldwide combination method of reporting.) This part of S. 1113 would not affect the application of the unitary method by those States which generally do not include the operations of foreign affiliates in the combined report. However, to the extent that such States actually tax foreign earnings when they are received as dividends, the provisions of S. 1113 regarding dividends received from foreign affiliates (discussed below) would apply.

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[14] Under subpart F, a foreign corporation generally is a controlled foreign corporation (CFC) if more than 50 percent of the voting power is held by "United States shareholders," that is, U.S. persons each of whom owns at least 10 percent of the voting power. The U.S. shareholders generally are required to include currently in their income (as a constructive dividend) their pro rata shares of certain undistributed tax haven and passive income of the CFC.

For purposes of the bill, an "income tax" is defined as any tax which is imposed on, according to, or in relation to an amount measured by net income. Thus, for example, a tax on the privilege of doing business in a State in a corporate form which is measured by net income would be an income tax. For purposes of determining whether the taxable corporation and a foreign corporation are affiliated, the bill defines the term "affiliated group" to mean a common parent corporation and one or more chains of corporations connected through stock ownership with the common parent corporation.

Certain corporations organized under U.S. law would be treated as foreign corporations for purposes of the bill, and, thus, their income generally could not be taken into account in determining the liability of the taxable corporation. A domestic corporation generally would be treated as foreign if less than 20 percent of its gross income for the preceding three years was from sources within the United States. (Such corporations generally are referred to as "80/20 companies"). Included in this category would be possessions corporations (Code sec. 936).

B. Exemption for Dividends from Foreign Sources

The bill also would prescribe a partial or complete exemption for dividends received by U.S. corporations from (1) foreign corporations and (2) U.S. corporations 80 percent of whose income is from foreign sources. These exemptions apply whether or not the corporations paying and receiving the dividends are affiliated.

Dividends from foreign corporations.--In the case of dividends received from a foreign corporation, the bill would provide that the amount of income to be taken into account may not exceed the lesser of (1) the actual amount of the dividend received, net of any foreign income taxes on the income but not reduced by foreign withholding taxes, or (2) a formula amount intended to take into account foreign taxes imposed on the dividend or on the income from which the dividend is paid.[15]

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[15] The following discussion assumes that the taxable corporation elects to credit, rather than deduct, foreign income taxes and that it has the 10-percent or larger interest in the foreign corporation required in order to
(Footnote continued)

The net effect of this limitation would be that where the aggregate rate of foreign income taxes paid by a U.S. corporation with respect to the dividends it receives from its foreign subsidiaries (grossed up by the foreign income taxes paid by the foreign subsidiaries which are attributable to the earnings distributed to the U.S. parent corporation) equal or exceed the present 46-percent U.S. Federal income tax rate, no part of the dividends received by the U.S. corporation from its foreign subsidiaries could be taxed by a State. Where the aggregate foreign tax rate is less than 46 percent, a proportionate part of the dividends would be exempt from State income tax (if the foreign rate is half of the Federal rate, half the grossed-up foreign dividends would be exempt; if the foreign rate is one-quarter of the Federal rate, one-quarter of the grossed-up foreign dividends would be exempt, etc.). Since many U.S. corporations pay (or are deemed to have paid) foreign income tax with respect to dividends from foreign subsidiaries at rates comparable to the 46-percent U.S. Federal income tax rate (determined on an overall basis for all dividends received by the U.S. corporation from foreign affiliates), it can be expected that, for many U.S. corporations, the bill would exempt from State income taxes most if not all of the dividends they receive from foreign corporations. (However, under the Tax Reform Act of 1986 (H.R. 3838), the Federal corporate income tax rate is reduced to 34 percent after 1987.)

The formula limitation is determined as follows: The first step under the formula is to determine the "grossed up" amount of the dividend by adding to the amount of the dividend the foreign income taxes paid by the distributing foreign corporation which are attributable to the dividend. This "grossed up" dividend amount is then multiplied by a fraction to determine the portion of the dividend to be excluded in determining the U.S. corporation's liability under the formula. The fraction takes into account not only the particular dividend under consideration but all dividends received during the year from foreign corporations by the U.S. corporation. The numerator of the fraction is the sum of (1) the foreign taxes imposed on the income of the foreign corporations from which the dividends are paid and (2) any additional foreign tax withheld on the payment of the dividends to the U.S. corporation. The denominator of the fraction is the grossed-up amount of all foreign dividends multiplied by 46 percent, the highest corporate rate presently in effect at the Federal level.

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[15] (continued)
claim the foreign tax credit for taxes paid by the foreign corporation which are attributable to the dividend (see Code secs. 902 and 960).

The operation of this formula is illustrated in the following example. Suppose that a foreign country imposes a net corporate income tax at a flat rate of 23 percent (half the current U.S. Federal rate) and imposes no withholding tax on the distribution of dividends. A foreign corporation earns $100 in that country, pays the foreign income tax of $23, and remits the remaining $77 to the U.S. corporation whose State tax liability is to be determined. The actual amount of the dividend is thus $77. The amount taxable under the formula is determined as follows. First, the $77 received is grossed up to include the $23 of foreign tax imposed on the income from which it was paid, for a total of $100. The portion to be excluded is determined by multiplying the grossed-up dividend amount ($100) by a fraction, the numerator of which is $23, the foreign tax paid, and the denominator of which is $46, the maximum U.S. corporate rate of tax on the $100 of income.[16] The resulting product is $50 ($100 X $23/$46), the excludable amount (half the grossed-up dividend). Thus, $50 ($100 minus the excluded $50) is subject to tax under the formula. Because this is less than $77 actually received, the State may not include more than $50, the amount determined under the formula, of the dividend in the U.S. corporation's income.[17]

If the foreign country's tax rate had been 46 percent, then the actual dividend received by the taxable corporation would have been $54. The grossed-up dividend under the formula would have been $100 ($54 plus $46). The excluded amount would have been $100 ($100 multiplied by $46/$46). Thus, none of the dividend would have been subject to tax by

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[16] The 5-percent surtax imposed on certain corporate income (to phase out the benefit of graduated corporate rates) is disregarded under the formula in S. 1113.)

[17] The actual amount of a dividend may be smaller than the formula amount if the taxable corporation also receives other dividends during the taxable year. This may be illustrated by returning to the example in which the foreign country imposed a 23 percent tax on corporate income and assuming that the U.S. corporation also received a dividend of $900 from another foreign affiliate during the year from which a foreign income tax of 5 percent ($45) was withheld. Under the formula, the grossed-up amount of the first dividend ($100) would be multiplied by a fraction, the numerator of which is the total foreign income taxes paid ($23 plus $45, or $58), and the denominator of which is 46 percent of the total grossed-up dividends (46 percent of the sum of $100 and $900, or $460). The excludable amount would thus be the product of $100 and $68/$460, or $15, and the taxable amount under the formula would be $85 ($100 minus $15). In this case, the actual amount of the dividend ($77) would be less

(Footnote continued)

the State.

The operation of these provisions is illustrated by the following example which compares the total income tax burden (State, Federal, and foreign) on $100 of income earned by a U.S. company with the total tax burden under the bill on $100 of income earned by a foreign affiliate of the U.S. company and paid to the U.S. company as a dividend. The State tax rate is 10 percent. In the case of U.S. operations, the U.S. tax base is $90 after deduction of State tax of $10.

	Taxation of operations in United States only	Taxation of foreign source dividends at different foreign tax rates			
		Zero	23%	46%	50%
Foreign tax....................	0	0	$23	$46	$50
Net U.S. tax (46%)............	$41.40	$41.40	20.70	0	0
State tax (10%)...............	10	10	5	0	0
Total taxes................	51.40	51.40	48.70	46	50

This example shows that under S. 1113 the total (State, Federal, and foreign) income tax burden of the foreign affiliate *declines* as the foreign income tax rises from zero to 46 percent.

Foreign source dividends from 80/20 companies (other than sec. 936 corporations).--In the case of foreign source dividends received from an 80/20 company other than one making an election under Code section 936, the bill would limit the amount of income permitted to be taken into account under the same rules applicable to dividends from a foreign corporation (discussed immediately above), applied separately to the 80/20 dividends and modified as follows: First, the numerator of the fraction used in computing the formula limitation would include, in addition to any foreign taxes withheld on the payment of dividends by the 80/20 company (and any other 80/20 companies paying dividends to the U.S. corporate recipient during the year), foreign income taxes paid or deemed paid by the 80/20 company (and any other 80/20 companies paying dividends to the U.S. corporation during the

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[17] (continued)
than the formula amount, and would be the maximum subject to State or local tax. As to the $900 dividend, the actual amount of the dividend is $900. Under the formula, the exclusion is the product of $900 and $68/$460, or $133. Thus the formula limit is $767, which is less than $900 and thus would apply. The total amount which could be included in the U.S. corporation's income with respect to the two dividends would be $844 ($77 plus $767).

year), in the same proportion with respect to the accumulated profits of each 80/20 company which the amount of the dividend bears to the amount of those accumulated profits in excess of all income taxes (other than those deemed paid). This modification ensures that, in the case of dividends paid by 80/20 companies, the numerator of the fraction includes all foreign taxes imposed on the income of 80/20 companies from which the dividends are paid. This additional inclusion of foreign taxes in the numerator is not conditioned upon the dividend recipient's ownership of 10 percent or more of the dividend payor's voting stock, as is the inclusion in the numerator of deemed paid foreign taxes in the case of dividends from foreign corporations.

Second, the dividend amount taken into account in the denominator of the fraction is grossed up by the additional foreign taxes just described. Third, the dividend amount multiplied by the fraction is grossed up by the portion of the additional foreign taxes just described that was actually paid or deemed paid by the dividend payor (as opposed to other dividend-paying 80/20 companies in which the U.S. corporate recipient owns stock).

Foreign source dividends from section 936 companies.--A separate rule would apply to exempt foreign source dividends received from an 80/20 company which makes an election under Code section 936 (a "section 936 company"). Unlike the rules which would apply to dividends from other 80/20 companies and foreign corporations, relief under this provision does not depend on the amount of foreign income taxes which the dividend bears. A State or locality would not be permitted to take into account the amount of any dividend received from a section 936 company to the extent that the recipient corporation is allowed a dividends received deduction under the Code. The dividends received deduction for dividends paid by a section 936 company generally is equal to 100 percent of the dividend.

C. Other Rules

Foreign taxes for which a credit is allowed under the Code's creditability rules (Code sec. 901) would be the only foreign taxes to be taken into account in applying the foregoing rules.

The bill would not subject any dividend, other income item or portion thereof to taxation, if that taxation is otherwise prohibited by any law, or rule of law, of the United States.

D. Effective Date

The provisions of S. 1113 would apply to taxable periods (under State or local law) beginning after December 31, 1986.

VI. DESCRIPTION OF S. 1974
(Senators Wilson, Mathias, and Hawkins)

S. 1974 was introduced at the request of the Administration. While its language in some respects follows draft language issued on July 8, 1985, by the Treasury Department to implement the recommendations of the Worldwide Unitary Taxation Working Group, S. 1974 differs in several major ways from the Working Group recommendations. (A companion bill, H.R. 3980, was introduced in the House of Representatives by Mr. Duncan.)

A. Prohibition of Worldwide Unitary Method

The bill generally would bar imposition by any State of an income tax on any taxpayer on a worldwide unitary basis. (In this respect, the bill differs from the Working Group recommendation, which would have allowed Federally obtained tax information to only those States that do not use the worldwide unitary method, but which would not have barred use of that method.) The bill defines worldwide unitary basis to mean that, in computing its State income tax liability, a corporation would take into account the income of another corporation, unless that second corporation both is a member of the same controlled group of corporations (control generally being defined as more than 50-percent common ownership) and is one of five kinds of corporations that may be part of a "water's edge group" (described below).

In two cases, however, a State could impose income tax on a worldwide unitary basis. First, if a taxpayer makes an unconditional election to be taxed on a worldwide unitary basis, a State may permit a taxpayer to be taxed on that basis. Second, a State may impose tax on a worldwide unitary basis if (1) the taxpayer materially fails to comply with certain compliance provisions of this bill, discussed below, or with the legal or procedural requirements of the State's income tax laws, or (2) neither the taxpayer nor the government of the relevant foreign country provides to the State, within a reasonable period after proper request, material information relating to the determination of the taxpayer's income on transactions between the taxpayer (or a related corporation within the water's edge group) and any related corporation that is not in the water's edge group.

The bill defines income tax to include any State franchise or other tax which is imposed upon or measured by the income of the taxpayer.

B. Foreign Source Dividends

As to dividends received by corporations from corporations outside the water's edge group, a State (other than the State of commercial or legal domicile of the corporation receiving the dividends) would not require the inclusion in income, for State income tax purposes, of more than an "equitable portion" (a defined term) of any such dividend. (The Unitary Working Group did not take a position on this issue.) For this purpose, a State will not be considered to include in its income base more than an "equitable portion" of dividends from corporations outside the water's edge group if it satisfies any of three tests.

First, it will satisfy this "equitable portion" requirement if it excludes from its income base at least 85 percent of those dividends (the same percentage as the current Federal deduction for dividends received from non-80-percent owned corporations, which applies generally to dividends from U.S. corporations but only in limited circumstances to dividends from foreign corporations). Second, it will satisfy this requirement if it excludes from its income base the portion of the dividend that effectively bears no Federal income tax by virtue of the foreign tax credit. This method is like that mandated by S. 1113, described above. Third, it will satisfy this requirement if it adopts a method of taxation, pursuant to regulations to be promulgated by the Secretary, that, considering all the facts and circumstances, results in an equitable apportionment of the dividend to the State substantially similar to the 85 percent exclusion or the exclusion that is analogous to the foreign tax credit. This provision does not permit State taxation of any dividend not subject to State taxation prior to enactment of the bill.

This limitation on taxation of dividends would apply not only to dividends from related parties, but also to portfolio dividends earned from passive investments, including portfolio dividends from foreign corporations.

C. Water's Edge Group

As indicated above, five kinds of corporations make up the water's edge group (that can be taxed under a combined unitary reporting method under the bill). The first kind of corporation in the water's edge group is a U.S. corporation, including a corporation that has made an election under section 936 (which primarily benefits Puerto Rico) to be treated as a possessions corporation. Under an exception described below, some U.S. corporations whose U.S. activities are below certain thresholds are excluded from the water's edge group. The second kind is a Foreign Sales Corporation entitled to certain U.S. tax benefits on sales of export property (described in sec. 922 of the Code). The third kind is a corporation organized in Puerto Rico, Guam, American Samoa, or the U.S. Virgin Islands.

The fourth kind of corporation included in the water's edge group is a foreign corporation with substantial U.S.

presence. To come within the water's edge group under this test, the foreign corporation must be subject to State income tax in at least one State by virtue of its business activities there. In addition, before it becomes a member of the water's edge group under this test, the foreign corporation must have activities in the United States rising to a certain dollar threshold or a percentage threshold. Under the dollar threshold, a foreign corporation becomes eligible for inclusion in the water's edge group if it has, assignable to one or more locations in the United States, at least $10 million in compensation payments made by it for services rendered during its most recent Federal taxable year, sales or purchases of at least $10 million to or from unrelated parties during its most recent Federal taxable year, or property (other than stock or securities of a corporation) with an aggregate original cost of at least $10 million. A corporation comes within the water's edge group if the average of the percentages of the foreign corporation's property (based on its aggregate original cost), compensation payments made for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that are assignable to one or more locations in the United States is at least 20 percent.

The fifth kind of corporation that can be a member of a water's edge group is a foreign corporation that neither performs substantially independent activities nor is subject, under standards established and regulations to be prescribed by the Secretary, to substantial foreign tax on its net income. Corporations included under this fifth test are sometimes referred to a "tax haven" corporation. To be included in the water's edge group under this fifth test, a foreign corporation must be a member of a controlled group that includes a "reporting corporation" (described below to include corporations with substantial foreign activities or substantial worldwide assets). In addition, a corporation, to be included in the water's edge group under this fifth test, must either carry on no substantial economic activity or make at least 50 percent of its sales, 50 percent of its payments for expenses other than payments for intangible property, or 80 percent of all of its payments for expenses to one or more related corporations that are in the water's edge group by virtue of the first four tests.

For the purpose of determining whether a U.S. corporation is in the water's edge group, a provision of the bill "mirrors" the $10 million/20 percent rule that applies to foreign corporations. Under this mirrored rule, a corporation is treated as a foreign corporation if it satisfies both a dollar amount test and a percentage test. A U.S. corporation satisfies the dollar amount test if it has, assignable to one or more locations in the United States, less than $10 million in compensation payments made by it for services rendered in its most recent Federal taxable year, sales or purchases of less than $10 million to or from unrelated parties during its most recent Federal taxable year, and property (other than stock or securities of a corporation) with an aggregate original cost of less than $10 million. A U.S. corporation satisfies the percentage test for this purpose if the average of the percentage of its property (based on aggregate original costs), compensation payments for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that are assignable to one or more locations in the United States is less than 20 percent. This exception could effectively eliminate possessions corporations (sec. 936) from the water's edge group, depending on the determination of the situs of sales of property produced in a U.S. possession such as Puerto Rico and sold into the mainland.

U.S. corporations that are outside the water's edge group under this percentage test are sometimes called "80/20" companies. (These 80/20 companies are to be distinguished from so-called 80/20 corporations for Federal income tax purposes (described in Code sec. 861(a)(2)(A)), whose interest and dividend payments are generally treated as foreign source under present law. For Federal purposes, the percentage test is based on gross income rather than property, payroll, or sales.) The Working Group took no position on whether these 80/20 companies should be includible in a water's edge group.

In certain circumstances, a U.S. branch of a foreign corporation will be treated as a separate U.S. corporation. First, if the branch of a foreign corporation is engaged in a commercial banking business, it will be treated as a separate U.S. corporation. For this purpose, a branch is engaged in the commercial banking business if the predominant part of its business consists of receiving deposits or making loans and discounts, and it is subject to supervision and examination by State or Federal authorities having supervision over banking institutions. Second, regulations may provide that domestic branches of foreign corporations in specified industries other than banking will be treated as separate U.S. corporations.

D. Reporting Requirements

The bill provides detailed information reporting requirements. (As mentioned previously, a corporation which fails to materially provide the required information may be taxed by a State using a worldwide unitary basis.) A reporting corporation (defined below) must file with the IRS, within 180 days of the due date (including extensions) of its Federal income tax for the taxable year, a return disclosing information relating to its State income tax returns for

State taxable years ending with or within its taxable years for Federal income tax purposes. This return is to include the reporting corporation's income tax liability, each State in which it is liable to pay tax, its income subject to tax in each State, the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each State, and a list of related corporations that have engaged in transactions with the reporting corporations (and the affiliates) aggregating $1 million or more. In addition, the reporting corporation is to furnish such other related information as the Secretary may by regulation prescribe.

If a reporting corporation is the common parent of an affiliated group, in filing the return described immediately above, it is to include the required information with respect to each includible corporation in its affiliated group. If a reporting corporation is a member of a controlled group that includes a foreign corporation that does not carry on substantial economic activity (or that deals primarily with related parties) and that is not subject to substantial foreign net income tax, but is not required to file a Federal income tax return, then that foreign corporation is considered to be a member of the affiliated group of which the reporting corporation is a common parent. No double reporting is required under this rule.

The bill defines a reporting corporation to mean a corporation that is required to file a Federal income tax return for the taxable year and that satisfies either a level of foreign activities test or a level of total activities test. A corporation satisfies the level of foreign activities test if it makes aggregate payments of at least $10 million as compensation for services rendered outside the United States during the taxable year, owns foreign assets with an aggregate original cost of at least $10 million, or has gross sales occurring outside the United States of at least $10 million during the taxable year. It satisfies the level of total activities test if it is subject to tax in at least two States, and owns total assets with an aggregate original cost of at least $250 million, at least $10 million of which are located in the United States. The Secretary is authorized to increase dollar thresholds for this purpose and to allocate compensation payments, property, or sales to (or among) foreign countries. The bill provides for the aggregation of compensation paid by, property owned by, or sales made by related members of corporate groups in determining whether the $10 million or $250 million test is met. In addition, a U.S. branch of a foreign corporation engaged in the commercial banking business in the United States is treated as a separate U.S. corporation for purposes of applying these reporting provisions.

If the information return or any information reflected thereon is disclosed or made available to a State tax agency or to any common agency (defined to mean a joint or common agency, body, or commission which has been designated under the laws of four or more States to represent those States collectively in the administration of the corporate income tax laws of those States, and which has executed a nondisclosure agreement) in which the State participates, such as potentially, the Multistate Tax Commission, the return is to be treated (if the State law so provides) as if originally filed with that State for the purpose of imposition of the State's criminal or civil penalties for negligence, fraud, or material understatement of income or of tax liability. Except as provided by State law, treatment of the return as a State return will not extend or otherwise affect any State's statute of limitations.

The bill provides a $1,000 penalty for failure to comply substantially with the information reporting requirement. The bill provides that, 90 days after mailing notice of failure to comply, continuing failures are subject to additional penalties of $1,000 for each 30-day period. The total penalty for one continuing failure cannot exceed $25,000.

E. Disclosure of Federal Information

The bill amends the Internal Revenue Code rules governing the confidentiality and disclosure of tax information. The bill provides that upon compliance with certain procedures and requirements (described below), return information with respect to the income tax, the self-employment tax, the consolidated return rules, the estate and gift taxes, the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, wage withholding, retail excise taxes, manufacturer's excise taxes, the excise tax on undistributed income of real estate investment trusts, the windfall profit tax on domestic crude oil, the excise taxes on distilled spirits, wines and beer, the excise taxes on certain tobacco products, and the excise tax on the use of certain highway motor vehicles shall be open to inspection by or disclosure to any State tax agency for the purposes of (but only to the extent necessary for the administration of) the State's tax laws. The same treatment applies to return information obtained by the Internal Revenue Service from a foreign government or agency or department thereof under the exchange of information provisions of any tax treaty or any Caribbean Basin Initiative exchange of information agreement. Information obtained under tax treaties or Caribbean Basin Initiative agreements is to be open to the examination or disclosure only to the extent that the treaty or agreement permits such disclosure.

The staff is unaware of any treaty or agreement that now permits disclosure of tax information to State taxing authorities. The bill would amend the requirements for exchange of information agreements under the Caribbean Basin Initiative legislation so that such exchange of information agreements must provide for the exchange of such information as may be necessary and appropriate to carry out and enforce the tax laws of the several States of the United States.

Return information described above that relates to a taxpayer that is either a reporting corporation or a member of an affiliated group that also includes a reporting corporation is to be open to disclosure to or inspection by any qualifying common agency such as, potentially, the Multistate Tax Commission.

Except as provided by regulations, inspection is to be permitted or disclosure made to State officials only upon written request by the head of the State tax agency or the common agency, and only to personnel listed in that written request. In no event is disclosure to be made to the Governor of the State or to a person who is not an employee or legal representative of the agency. Disclosure may be made to a person listed in regulations prescribed by the Secretary as necessary in connection with processing, storage, programming, and the like, for purposes of tax administration (under sec. 6103(n) of the Code). There is to be no disclosure to the extent that the Secretary determines that disclosure would identify a confidential informant or seriously impair a tax investigation.

A State agency or common agency obtaining returns or return information described above may disclose those returns or return information to a State tax agency of an other State so long as that other agency has entered into a nondisclosure agreement with the Secretary that prohibits the disclosure of those returns or return information or of any data, information, or conclusion extracted from or based upon these returns or return information except for the purposes and under the conditions provided in the Internal Revenue Code provision governing confidentiality and disclosure of return and return information (sec. 6103). The required nondisclosure agreement is to contain such terms and conditions as the Secretary may prescribe.

These returns or return information obtained by a State tax agency are to be open to inspection by or disclosure to officers and employees of a State audit agency for the sole purpose of making an audit of the State tax agency. State audit agencies are not to have access to return information obtained under a treaty or a Caribbean Basin Initiative Agreement. For this purpose, a State audit agency is any State agency, body, commission, or entity which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

F. Effective Date

The bill would be effective for taxable years beginning after 1986.

Senator CHAFEE. I want to welcome everyone here this morning. This is a hearing before the Subcommittee on Taxation and Debt Management on the unitary tax; and we are going to hear testimony on two bills which would restrict the use of the worldwide unitary method of taxation by the States, S. 1113, introduced by Senator Mathias, and S. 1974, introduced by Senator Wilson.

Under the unitary tax methods, a State determines a company's State tax liability based upon the worldwide income of the company in an apportionment formula, usually based upon sales, payroll, and/or assets in the State. Over the last several years, foreign governments have repeatedly petitioned the Federal Government to act to curb State use of the worldwide unitary method of tax.

The United Kingdom, in July 1985, adopted an antiunitary retaliatory legislation for which implementation has been deferred. In September 1983, President Reagan established a worldwide unitary taxation working group to provide recommendations suitable for resolving the issues raised by this worldwide method of taxation.

In transmitting the report of the working group to the President, its chairman, then Treasury Secretary Donald Regan, indicated that he would recommend restrictive Federal legislation if substantial voluntary progress had not been made On the worldwide unitary issue at the State level by July 31 of last year, 1985. Subsequently, some States have changed their laws to conform to the working group principles while others continue to use the worldwide unitary method.

California just recently repealed the unitary method, but Alaska, North Dakota, and Montana—just three States—still use it; and I am aware that even in cases of repeal, there may still be some open issues with regard to the taxation of dividends from foreign subsidiaries, and I suspect perhaps Senator Wilson might comment on that in his testimony.

On November 8 of last year, President Reagan directed the Secretary of the Treasury to submit proposed legislation to the Congress regarding the worldwide unitary tax issue. That legislation is embodied in S. 1974, one of the bills we are considering here today. Now, this is an important issue. We have a number of excellent witnesses to testify, both in favor of the method and against it; and I look forward to hearing that testimony and, of course, I especially welcome our first two witnesses, Senator Mathias and Senator Wilson.

Senator Mathias has been concerned about the unitary tax for some time. He introduced one of the bills. And of course, Senator Wilson has been active in this field also. So, both of you gentlemen, we welcome you here. Senator Mathias, why don't you proceed?

Senator MATHIAS. If that is agreeable to Senator Wilson, Mr. Chairman.

Senator CHAFEE. Is there a time constraint?

Senator MATHIAS. No.

Senator CHAFEE. All right. Why don't you proceed, Senator Mathias?

STATEMENT OF HON. CHARLES McC. MATHIAS, JR., U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. First of all, Mr. Chairman, I would like to congratulate the committee. You completed a very difficult and really monumental task at 4 o'clock on Saturday afternoon, and here at 9:30 on Monday morning, you are starting a whole new job, which is just about as tough.

Senator CHAFEE. Oh, excuse me. Senator Baucus, did you have an opening statement?

Senator BAUCUS. No, Mr. Chairman, thank you.

Senator CHAFEE. All right. I want to thank you for the compliments to the Finance Committee. This Finance Committee never sleeps. [Laughter.]

We are always diligently working for the people of the Nation.

Senator MATHIAS. We can believe it, and I hope you can push this one through before the adjournment sine die. [Laughter.]

The chairman was kind enough to note that I have been engaged in this for some time. That is, in fact, the case. My activities in this field go back, I suppose, over 20 years when I was appointed as an original member of the Willis Committee in the House of Representatives. I may be the last surviving member of the Willis Committee still in the Congress, but that was a committee appointed to try to resolve this problem. And in fact, we did develop a bill based on a three-factor formula which passed the House of Representatives, but we have never been able to get it through both Houses at the same time. So, the problem still is here.

The interesting thing, Mr. Chairman, is the mutation this problem has undergone, because when the Willis Committee undertook its study, it was primarily an interstate problem. It was a problem burdening the interstate commerce within the country. But because of the great growth in our international trade, it is now an international problem of great significance and it is not only burdening international trade, it is also affecting international relations.

As the chairman has just noted, the British Parliament has enacted retaliatory legislation, and this is the seed of a very serious controversy, and it is the kind of controversy with which we are familiar.

Without getting into a lot of American history, I might note that it was when Maryland and Virginia began to fuss over who could fish in the Potomac River and who could sail ships through Cape Charles and Cape Henry that we were forced to realize that we needed something stronger than the Articles of the Confederation. And that led to the Annapolis Convention and then on to the Philadelphia Convention and the adoption of the Constitution.

So, historically, we must realize that this is the kind of problem for which a Federal solution is appropriate, and there must be a Federal solution. I am very encouraged by the action of the State of California, and I congratulate Senator Wilson because I think the California repeal of their previous law is a great advance and certainly makes the climate a lot better; but it does not solve the problem, as the chairman noted.

There are not only some States which still have unitary tax systems in full force and vigor; there are also a number of discrepancies among the States in their various approaches to the problem. And of course, uniformity, or at least a reasonable degree of uniformity, is essential if we are to have a smooth flow of commerce.

I wish I could say that this very welcome California action was dispositive of the problem, but it really isn't. And it is not, as I say, merely the fact that we have some holdouts, but it is the fact that this really is not a problem which, in my experience in dealing with this for 20 years, is likely to be permanently solved at the State level; and I say that with great deference, knowing that the chairman is a former Governor and is as adamant in upholding States' rights as anyone in the Congress. But we tried for a number of years to go the compact route. There were pious hopes held out that the States could come together and create a compact which would solve this problem, and it proved to be just an illusion. It is not going to happen.

I think we need some rational, reasonable guidelines at the Federal level. I think that the action in California, rather than discouraging Federal action, ought to give us the hope that this is the appropriate time for Federal action. We ought to move forward and resolve this problem as rapidly as possible before other nations follow the British example and before the problem deteriorates into a very nasty situation affecting not only commerce but other aspects of our relations in the world.

Mr. Chairman, I think that is enough from me. If I may have consent to file a statement which will put forth in a little more detail the thoughts that I have tried to express very briefly here?

Senator CHAFEE. Fine. A quick question: What is the British proposal? What are the British suggesting that they would do—not only suggesting, I guess they have passed it—but deferred it. What does their legislation do?

Senator MATHIAS. In fairness to the British, let me say that they came to us several years ago, and they said this was a serious problem and that they would have to invoke some kind of a tax retaliation if we did not get our unitary tax problems under control. They gave us several years' notice and, even now, they have provided that the bill that they have passed should not go into effect until we have one more chance.

Not only have members of the British Parliament come to the Congress but Mrs. Thatcher herself has made it a primary part of her agenda when she has been in Washington. So, they have played very fair with us on it. The retaliatory legislation would withhold tax credits for American companies doing business in Britain, or companies that fall within their jurisdiction, which would be comparable to the exactions which are taken out under the unitary tax system imposed on British companies doing business here.

Senator CHAFEE. All right. Thank you very much. I know you have a busy schedule. Senator Baucus, do you have any questions?

Senator BAUCUS. Thank you, Mr. Chairman. Mac, I am just curious about something you said. You said this problem requires a Federal solution. Can't one say that there is already a Federal solution, namely the Federal constitutional decision? The Supreme

Court has ruled on this matter, saying that States may impose these kinds of taxes insofar as these kinds of taxes—the worldwide unitary system—do not violate the U.S. Constitution.

And second, isn't there a Federal solution in that insofar as States or laboratories and experiments and so forth go, the trend is away from worldwide unitary? States are repealing and are modifying. California is the best example. So, isn't there already a Federal solution? Is it worth the price to have to pass a Federal statute interfering with State taxing power, given the Supreme Court decision and the trend in States to repeal the worldwide unitary system? Isn't that Federal solution working out?

Senator **Mathias**. To deal first with the Supreme Court decisions, it is true the courts have said that what the States are doing is within their constitutional power in the absence of some congressional solution. The court has emphasized that repeatedly and has really tossed the ball right into the congressional court. They said what States are doing is not beyond their constitutional powers; but if they are creating a problem, the problem has to be solved by Congress. And the court has really urged the Congress in several decisions to move on this problem and solve it.

What the court have really said is that they can't solve it because the States are within their constitutional bounds in imposing the taxation but that those bounds can be limited, lawfully limited, constitutionally limited, by the Congress. And I would read—maybe because my views are so strong on this subject—into the court's decisions an invitation for the Congress to act. So, that would be my first answer.

Second, the trend for the States to move in this direction is an encouraging one. I certainly agree with you on that. But we have had high hopes before that the States would resolve this, that there could be an interstate compact. A compact was developed, and several States adhered to it. I have forgotten the number, but it is discouraging.

You look at how States have entered the compact and then withdrawn from it. There has been an ebb and flow, and it is that ebb and flow which I wish you would get the staff to look at for you, rather than depend on my imperfect memory. That ebb and flow of membership in this compact, followed by withdrawal from the compact, is, I think, the evidence that Federal action is required. States change, Governors change, legislatures change, the urgency of State revenue needs change; and we need, in the larger, long-term interest of the Nation, some guideline, some solution which will be understood not only by American companies with investment in other countries but also by our trading partners around the world, who find it very difficult to be tracking the activities of 50 State legislatures as they are planning their business activities in the United States.

So I think for a healthy commerce with the world, we really need to move in a rational, reasonable way with explicit guidelines that will be long-term rules for taxing commerce.

Senator **Baucus**. As a member of the Judiciary Committee and as a student of the Constitution, and particularly the separation of powers, and more particularly under the 10th amendment—the rights reserved to States—and particularly the fundamental taxing powers that all governmental entities must have, do you think, given the trend, that repealing the worldwide unitary or modifying it significantly is worth the price of Congress going into that thicket of beginning to limit and modify State taxing powers—the rights of States to raise revenues?

Senator **Mathias**. In this case, I would say yes because the stakes are so very high and because of the fact that we have tried for almost a quarter of a century to do it the other way and it hasn't worked. While we have been attempting the voluntary route, the problem has grown from an interstate to an international problem, the dollar volume has grown exponentially, and I believe that this is the only solution.

Just as when the Virginians tried to tax the Marylanders who went through Cape Charles and Cape Henry, we had to resort to adopting the Constitution, so here in this case where State legislatures are taxing commerce, I think we have to use the Constitution that was adopted as a result of that incident. These are valid constitutional powers; this is one of the very basic reasons that the Constitution was written; and since it was written and adopted and ratified, I think we should use it.

Senator **Baucus**. Mr. Chairman, I might say that I personally have a problem with the worldwide unitary system myself, but I also firmly believe that the States have a right to enact the kinds of taxes they think appropriate and proper. And there is a line that States may hypothetically cross which would require Federal legislative corrective action. In my judgment, Mr. Chairman, we have not crossed that line.

The trend is for States to repeal. The Supreme Court has ruled that the State action does not violate the Constitution. And third, I think the price we would pay in enacting this legislation would be way too dear, way too severe, compared with the relatively minor problem today in view of California's action. Thank you.

Senator **Chafee**. We have 11 more witnesses. So, you might be persuaded by their conclusions.

Senator **Baucus**. I might be.

Senator **Chafee**. Thank you.

Senator **Mathias**. Mr. Chairman, in light of Senator Baucus' comments, I not only ask unanimous consent to file my statement but to revise it and extend it so that we can cover those questions.

Senator **Chafee**. All right. To me, it is amazing that more States haven't taken this attractive source of revenue. Senator Wilson, we are delighted you are here, and you have been long active in this, even before the repeal of the California statute on this. Whether your actions and the California actions were cause and effect, I don't know, but we are prepared to give you the credit.

[The prepared written statement of Senator Mathias follows:]

Statement of
Senator Charles McC. Mathias, Jr.
Before the Senate Finance Committee

September 29, 1986

Mr. Chairman, thank you for inviting me to share with the Finance Committee my perspective on the unitary method of corporate income taxation.

We are meeting this morning in the wake of a dramatic change in the landscape of the unitary tax debate. California has fundamentally reformed its laws governing the taxation of foreign source corporate income. Although the new California law does not contain everything that Secretary Baker, Senator Wilson and I have been trying to achieve by federal legislation, it is a serious and welcome response to our efforts. I think this hearing will serve a useful purpose of reviewing the California action and of keeping up the encouragement to the remaining unitary states (Alaska, North Dakota and Montana) to mend their ways.

Under the unitary method, a state takes into account the entire revenues of a corporation in all parts of the world, and then applies a formula to determine the corporation's tax liability in the state. The arm's length method favored by the federal government, by most of the states, and by all other industrial countries of the world, treats foreign affiliates and subsidiaries as separate business entities and taxes income earned abroad only when it is repatriated, allowing a credit for taxes already paid in the source country. The extraterritorial taxation involved in the unitary method has impeded both foreign and domestic business investment in the states that have practiced it, and has caused painful tensions in our trade relations with Great Britain and other countries that refrain from using this method. On these grounds, I have advocated throughout my career in Congress the elimination of the unitary method.

We shouldn't forget this issue's deep historical roots in our country's infancy. I take you back to the year 1784, when a dispute broke out between the watermen of Maryland and Virginia over the control of fishing on the Potomac River, which, under the original land grant from Charles I, is totally within Maryland. The Virginians reacted to the curtailment of their freedom to fish in the Potomac by restricting the transit of Maryland ships through Cape Charles and Cape Henry -- the only passage between the Atlantic Ocean and the Chesapeake Bay. Maryland shipping was blockaded, and Virginia fishing suspended, except on the onerous conditions each side laid down. The Articles of Confederation, which had governed the states since independence, provided no method for resolving this kind of dispute and only George Washington's personal invitation to meet at Mount Vernon produced a solution -- the Potomac Compact of 1785.

The dispute had revealed a major flaw in the organic law of the United States that needed to be addressed, and General Washington and the Mount Vernon delegates asked a more representative group to meet in Annapolis to consider some refinement of the Articles in the limited area of removing interference with interstate commerce.

The convention in Annapolis, whose bicentennial we celebrate this month, couldn't agree on the best way to carry out this specific mandate. It proposed, however, to call a second session to meet in Philadelphia to complete the job.

When the Constitutional Convention finally gathered in 1787, it moved on to many other important topics, but the original impetus that led to the convention of the independent commonwealths was prominently reflected in the Commerce Clause in Article I, giving Congress the power to "regulate commerce with foreign nations and among the several states...".

Problems relating to state taxation of interstate commerce have increased in direct proportion to the increases in the volume of such commerce. In the era following the Second World War, as international trade rapidly came to assume a central position in the separate economies of the world's nations, the vagaries in the tax policies of the various states began to affect not only domestic businesses but also foreign corporations, and foreign governments as well.

A task force appointed by President Reagan recommended that the unitary states be given a one year grace period in which to repeal the offending laws. Colorado, Florida, Indiana, Massachusetts and Oregon all came clean during this period, but enough stragglers remained, including California, that the President needed to make good on his ultimatum. Accordingly he instructed the Department of Treasury to draft a new version of my bill S. 1113 (which had been introduced every Congress since the 96th). The result, S. 1974, was introduced last December by Senator Wilson of California, with myself and Senator Hawkins as cosponsors. With the general income tax reform proposal on the boards, naturally the Finance Committee has had no time to turn to this measure until today. But the bill has had an effect all the same. In August, the California Assembly approved a bill to reform its unitary system, and Governor Deukmejian signed the legislation on September 5.

The thrust of the new California law is to allow multinational corporations to elect the arm's length rather than the worldwide unitary method of calculating their tax base in the state. The law has its shortcomings. It doesn't take effect until 1988. Corporations must pay a special fee if they elect to be taxed under the arm's length approach. Also, companies that have 80 percent or more of their business abroad are disqualified from electing arm's length treatment.

But despite these weaknesses, the California action is a resolute and decisive step forward. It is a great relief and comfort to me personally to be able to leave this issue on such a positive note, after so many years of stagnation and frustration. But I also know from experience in this area that progress can be followed by backsliding, so I urge this Committee to remain vigilant in the years ahead.

Additional Remarks of
Senator Charles McC. Mathias, Jr.
Senate Finance Committee Hearing on
the Unitary Method of Taxation

Following my presentation at the September 29 hearing, Senator Baucus raised two questions: shouldn't the rulings of the Supreme Court in recent years to the effect that the unitary tax systems practiced by some states are constitutional deter the Congress from trying to solve the problem by federal legislation prohibiting the unitary tax? And secondly, doesn't the recent trend among the unitary states toward repeal or modification of their policy render Congressional action unnecessary?

To supplement my response at the time, let me comment briefly on a few of the major Supreme Court decisions in this area over the past decade. The 1978 decision in Moorman Manufacturing Co. against Bair concerned the tax imposed by the state of Iowa on an out-of-state corporation. The majority of the Court found the tax to be constitutional, but specifically indicated that Congress has full authority to enact corrective legislation in this area. In the court's view:

> [T]he prevention of duplicative taxation ... would require national uniform rules for the division of income.

The Court then stated:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding national interest in uniformity, the content of any

> uniform rules to which they must subscribe should be determined only after due consideration is given to the interests of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not to this court, that the Constitution has committed such policy decisions.

The dissenting opinion did not quibble with the premise that a national standard was desirable. Its point, however, was that the Court already had sufficient power under the commerce clause of the Constitution to strike down the offensive tax formula.

The majority disagreed, noting that this --

> ...view of the Constitution...would require extensive judicial lawmaking.

In the summer of 1982, the Supreme Court gave a big boost to unitary tax reform efforts in its decisions in ASARCO v. Idaho and Woolworth v. New Mexico. In those cases, the court implied that the fundamental criterion for defining a unitary business is "flow of goods" rather than the broader criterion of "corporate purpose." Under this criterion, the Court ruled that the foreign dividend-paying subsidiaries of ASARCO and Woolworth were not part of a unitary business, and that taxing the dividends paid by those subsidiaries to ASARCO and Woolworth violated the due process clause of the Constitution. In establishing a more stringent threshold for what constitutes a unitary business, these decisions went further than my bill would in restricting taxation of dividends from non-unitary overseas subsidiaries.

In the Container case, however, the Court retrenched by saying it would not overturn a state court's decision about whether a foreign subsidiary is unitary with a corporation in the state, unless it finds clear and cogent evidence that the state's decision is beyond the realm of permissible judgment. This is an extraordinarily high standard of proof for the taxpaying corporation. The business community regarded the Container decision as the equivalent of an overturning of ASARCO and Woolworth. The Court, incidentally, cited absence of action in Congress as a factor in its decision. As a result of the Container case, the President set up the Working Group on the Worldwide Unitary Tax in September of 1983, whose report eventually led to the Administration's decision to endorse federal legislation to solve the problem.

Senator Baucus' second question was why Congressional action is necessary in view of the clear trend among the states to repeal the worldwide unitary tax. My reply is that the state legislatures are too susceptible to the immediate economic pressures at a given time not to be tempted to revive a unitary tax law even if they have voluntarily abandoned such a policy in the past. There is ample evidence of this danger. I mentioned the ebb and flow of membership in the Multistate Tax Commission, a voluntary association of states designed not to eliminate the unitary tax but simply to try to bring about more uniformity in the state tax laws. The following states became members and then left the Compact: Florida, Illinois, Indiana, Nebraska, Virginia, West Virginia. At present, 18 states and the District of Columbia are members.

Let me illustrate the problem of vacillation in the attitude of the states toward the unitary tax with some recent examples. Shortly after the Supreme Court's decision in the Container case, Florida adopted the worldwide unitary apportionment to solve some of its short-term budget problems. About half the multinational corporations that do business in Florida approached the state's Economic Development Division to express concerns about the new tax: Sony, IBM, Proctor and Gamble, Motorola and Coca-Cola all told the Florida lawmakers that the new unitary tax would weigh heavily in their future investment decisions. Florida has since repealed the law.

Other states have had similar experiences. In 1982, Oregon lost a major American chemical plant. One of the leading reasons was the state's new worldwide combined corporate income tax. Oregon has now repealed its unitary tax as part of a general economic recovery program. The same year New York passed a unitary tax on oil companies to aid mass transit. As a result, Mobil Oil moved a 380-employee operation from New York to Pennsylvania. The next year, too late to keep Mobil, the New York legislature repealed that tax.

Unless a federal law is put in place to prohibit worldwide unitary tax methods, the persistent short-term revenue needs of the states will perpetuate the state of uncertainty that is clouding the investment climate and creating diplomatic tensions with foreign governments. A full and equitable solution, that is also reliable and lasting, will require action by Congress.

STATEMENT OF HON. PETE WILSON, U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator WILSON. Thank you, Mr. Chairman. That is very generous of you. I am not sure that the legislature there would; but in any case, my history is not quite as long in this issue as is that of Senator Chafee, but even before coming here—in fact, long before coming here—I had more than a casual interest in this subject because as a mayor of the second largest city in California, I felt that the efforts that I was continually obliged to make in scrambling for new industry, to accommodate the jobs of the new population that incessantly comes daily to California, that success was being impaired substantially by the existence of a unitary tax which, rather than encouraging investment from foreign sources, was discouraging it.

I may be obliged to file this for the record and spare you; you may advance on your time schedule.

Mr. Chairman, before addressing this issue, I do wish to thank you and Chairman Packwood for accommodating both Senator Chafee and me and others who are interested in this issue by having this hearing when Chairman Packwood gave me assurance that he would hold the hearing upon the disposition of the tax reform bill. I must confess that I was a little disspirited by that because I wasn't at all sure last winter that we would ever get to this point. I congratulate him and you and others who have brought it to pass, and I must say that you have all been as good as your word. Here we are, less than 48 hours after the Senate has agreed to the conference report; so I again congratulate you and Senator Packwood and, true to his word, we are here.

Mr. Chairman, when I introduced S. 1974, the Unitary Tax Repealer Act, in December of last year, along with Senator Mathias and Senator Hawkins, I did so for one very simple reason; and that was that the use by a small group of States of the worldwide unitary method of taxation was threatening to touch off an international tax war, as you have observed, between our country and some of our closest allies and trading partners. President Reagan gave his pledge to our trading partners that he would seek congressional action that would preempt the States imposition of the unitary tax, and his proposal to do so is embodied in S. 1974.

Almost from the beginning of our Nation, as both you and Senator Mathias very eloquently have recited that history, there have been instances of conflict between the desires of the States and the interests of the Federal Government.

Such is the case with the use of the unitary tax method. Few things are as near and dear to a State's Governor, as I am sure you would agree; and I would recall from my days in the legislature the States' power to tax. So, I am sure that it was not lightly that the President, himself a former Governor, decided to call for Federal preemption and it was not without careful consideration that I decided to sponsor the administration's bill.

I will later have a word to say in response to Senator Baucus' question with regard to constitutionality; but nonetheless, as fundamental as the States' taxing power may be, it cannot be allowed to disrupt the free flow of international commerce and, indeed, a case that I am going to discuss later is one that rests upon the commerce clause.

Seeing such a disruption, it is evident that the Federal Government must step in. This is not a violation of federalism; I would argue that instead it is a mandate of federalism. Among the group of States that were utilizing the unitary method at the time when I introduced my bill, the largest was my State of California, which parenthetically has an economy greater than all but six nations.

And despite repeated efforts of many in my State, the unitary tax remained on its books. I am pleased—and that doesn't quite describe it—that in the ensuing months for most corporations operating internationally, California repealed its unitary tax. And after the hard work of many in the legislature and the leadership of Governor Deukmejian, the new tax law was signed on September 5.

This change in California's tax laws was not easy for there was significant cost to the State treasury, a cost that was somewhat reduced by reconciling State law with the Federal tax reform bill; but it was a cost that Governor Deukmejian and the legislature realized must be paid to address reasonable international concerns and to retain California's attractiveness as a State in which to invest.

Briefly, the new State law allows companies to opt out of the unitary system, electing to be taxed on a water's edge basis. Those making this election must pay a fee of 0.03 percent on its assessed property, payroll, and sales in California, though this could be reduced to 0.01 percent if investment in the State is increased over a certain base level. Seventy-five percent of foreign source dividends would generally be excluded from a company's income.

Finally, the effective date of the law is January 1, 1988, which responds to the threat of the retaliatory legislation enacted by the United Kingdom.

These changes are commendable and, in fact, were necessary in order to forestall that retaliation by the United Kingdom and that threatened by virtually all of our trading partners who have registered disapproval. And while I am pleased to see this major new law on the books, like the Federal tax reform bill, it may need a bit of refinement in the next year. Indeed, Mr. Chairman, the legislature realized that its work might not yet be done when it ordered a study be completed early next year on the new law's treatment of U.S. incorporated companies doing business abroad, so-called 80/20 corporations.

It is not enough to address international concerns, if it is done in such a way that some U.S. companies are left at a competitive disadvantage in overseas markets. Such a situation would undercut our country's efforts to arrest our runaway trade deficit. And if the only option is for a company to change its place of incorporation to a foreign country, this, too, clearly could threaten to undercut our international competitiveness if, in so locating, a company would endanger its trade secrets, its patents, its trademarks, or copyrights.

These are the major questions on which California must focus next year in reviewing the study of the State franchise tax board. As for Federal remedial efforts, it appears that there is no immediate need—at least the urgency that existed a year ago this time.

Three States—Montana, North Dakota, and Alaska—retained the unitary method, but the sheer size of California's economy and the sheer number of multinational corporations operating there makes its final resolution of the issue most significant to the debate at the Federal level.

I would, at this point, simply ask that the committee continue to follow the consideration of the unitary tax issue by California and by the three remaining unitary States to see how they resolve the remaining problems, both from the perspectives of international economy and also that of U.S. international competitiveness.

With regard, Mr. Chairman, to the very pertinent question asked by the Senator from Montana, a distinguished member of this committee, I would point out that what is at stake here is not the authority under the Constitution of a State to tax. I think that is beyond question, but what complicates the question and what we are dealing with here is the sourcing of income within the borders of the States.

There is no question, I should say, that there is authority reserved under the Constitution to tax income and activity that can be legitimately sourced within the borders of the State; but I think that the question is much less clear when we are talking about what is in fact the target of the unitary method. There is a conflicting provision, the commerce clause, which modifies the right reserved to the States to tax income and activity generated within its own borders. The Supreme Court, I think, has determined that limited indirect Federal involvement in some aspects of State taxation is not an infringement on States rights. In fact, in the *Mormon* case in 1978, it stated:

> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income.

So, again, what we are doing is not prohibiting the ability to tax. Legislation that seeks to prohibit unitary worldwide income taxation doesn't change the States' taxing jurisdiction. The States retain territorial taxing jurisdictions; they are free to tax all income that arises within their borders, but legislation prohibiting worldwide unitary income taxation, while not affecting the level or the rate of State taxation once income has been sourced within the States' borders, does aim at a different target.

It says that while the States are free to tax at any rate and by any method that they choose that income generated within their own borders, they are not permitted to engage really in a taxation that would interfere with the commerce clause; and I think that very clearly that is what has arisen, and that is what has given rise to the retaliation by the United Kingdom, which is contingent upon our responding by the end of this year.

So, Mr. Chairman, I think that harmony requires not only that we address the problem, but it also requires—as I think you will be told by Secretary Mentz when he testifies—that the United Kingdom forebear from what would in fact be a violation of tax treaties that we have with them and with our other trading partners; but the ugly situation, as Senator Mathias described, has developed and it is that in the view of the United Kingdom and others, we have violated that tax treaty.

I think that there is a need to go further, but at this point, I think that we should not only commend California for its efforts, but also work with them as they go forward on the study that seeks to determine the need to refine further the legislation that they enacted less than 3 weeks ago. I thank you very sincerely for the cooperation which you, Mr. Chairman, have afforded in particular to bringing about this hearing date. I like to think that the knowledge that there was to be a hearing and that there were two pieces of legislation has at least had a salutary encouraging effect on the efforts in California.

Senator CHAFEE. Thank you, Senator Wilson. I am interested in this, and I am looking forward to hearing the extent of the problem nationally because I think that it is a serious one. I noticed the States involved; there are only three States, and they are not major manufacturing States although I suppose all of them have a considerable amount of international trade. Let's see how much of a problem that is. In other words, if the problem is minor, we would probably be reluctant to have Federal legislation and, obviously, we would prefer that the States take some kind of action, as California has. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman. Senator Wilson, I want to compliment you. You have done a super job here. I think it is clear that the worldwide unitary system has caused some problems, not only for major international companies, but also for Great Britain and some other countries. And you have worked hand on this issue. Frankly, I think as a matter of policy, you are not too far off the mark. The question is how we resolve it. It seems to me there are three very basic questions. One, do the States that employ the worldwide unitary system violate the foreign commerce clause of the Constitution? Do they impede commerce? The answer to that is clearly "No." The Supreme Court has spoken on that issue, squarely; no, they do not under the Constitution.

The second question that you raised is does the Federal Government have the power to limit States' unitary method. And again, that is clear; yes, it does have the power. I think we have the right under the supremacy clause to do so, under the foreign commerce clause to do so.

The third question, though, is: Should we? Should the Federal Government so limit? That is the question we are facing here. And I just suggest that in view of State trends, in view of the size of the economies of the three remaining States—which do not quite match that of California's—though we in Montana hope that we are moving in that direction and particularly due to the difficulty many States are having these days in raising revenue, the unitary method should remain an option.

As we here cut back in grants to States and revenue sharing, et cetera, States are under more and more pressure to raise revenue if they so choose. The States should have that right, should have that option; and I don't know that we should begin to go down that slippery slope, down that trail of limiting States rights to raise revenue when, in this particular case, the Supreme Court has ruled that the Constitution is not contravened, not violated, and also because the trend is for States to cut back on their own volition.

States want to attract foreign commerce. They want companies to do business in their States, and I think that is the reason why California modified its laws, and it is also why various States who still have the unitary tax are at least addressing the question of whether they should so modify. But I think, the bottom line is that given the circumstances, it would be inappropriate for Congress in the year 1986 to so limit States' taxing authority. Thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much, Senator. We appreciate your testimony.

Senator WILSON. Thank you very much.

Senator CHAFEE. If you would like to sit up here, we would be delighted to have you; or if you have other engagements, of course, we would recognize that.

Senator WILSON. Thank you very much, Mr. Chairman. I might, as a parting comment, say that I think that Senator Baucus' observation about the motivation that the States have may be dispositive of the issue and make academic further effort. I think the jurisdiction that we have to act is not only a continuing impetus to do so on the part of the States, but if the experience that these States have is like that of California, they will encounter, I think, some would-be investors who are quite outspoken in their articulation of this as an impediment to investment.

The best example I can think of that is Mr. Morita, chairman of Sony, who told the former Governor of California—not Governor Reagan, but Governor Brown—that in no uncertain terms his desire to expand his operation, which already existed in my city, was not going to go forward precisely because he was unwilling to see his worldwide assets subjected to the unitary method of taxation. And he was as good as his word. He did expand and not in California. Thank you.

Senator BAUCUS. And not in Montana.

Senator WILSON. And not in Montana.

[Laughter.]

Senator CHAFEE. All right. Thank you very much, Senator. And now, Roger Mentz, Assistant Secretary for Tax Policy, Department of the Treasury. Why don't you proceed? And if you want Mr. Chapoton or anyone else with you, that will be fine; they are free to join you. Mr. Mentz.

STATEMENT OF HON. J. ROGER MENTZ, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MENTZ. Good morning, Mr. Chairman and Senator Baucus. I, too, would like to congratulate the Senate Finance Committee on a major victory on tax reform, the President's No. 1 priority. Like the Senate Finance Committee, the Treasury Department never sleeps. Although there are those who wish we did. [Laughter.]

I think it is fitting that this hearing comes so immediately on the heels of tax reform because unitary tax is also a very high priority issue within the Administration. In my judgment, we are close to a solution to this vexing problem.

It is my pleasure to present the views of the Treasury Department on S. 1974, the bill introduced by Senator Wilson that addresses State taxation on the worldwide income of corporations and their affiliates. In general, this bill would prohibit States from levying corporate income taxes on a worldwide unitary basis, would require States to tax foreign source dividends in an equitable manner, and would provide additional Federal assistance to the States for the administration and enforcement of their corporate income taxes. As you know, this legislation was drafted by the Treasury Department at the express direction of the President and was introduced last December with the full support of the administration.

Senator CHAFEE. Mr. Mentz, I know you have a lengthy statement.

Mr. MENTZ. Yes, and I am not going to read it all.

Senator CHAFEE. All right.

Mr. MENTZ. I will keep it brief and then take questions.

Senator CHAFEE. We will put it all in the record.

Mr. MENTZ. All right, fine. As you know, we have the result that all States except three have adopted some form of water's edge unitary approach. The three States that have not are Alaska, Montana, and North Dakota. They still continue to have a worldwide unitary basis tax. They are still a problem. Furthermore, California's legislation also has some elements in it that are inconsistent with the President's statement, and with S. 1974. We believe, however, that since there has been such significant progress that restrictive Federal legislation is not warranted at this time.

Senator CHAFEE. What significant progress, if I could interrupt? Other than California, has anybody else repealed?

Mr. MENTZ. Yes. All other States except three; we are left with Alaska, Montana, and North Dakota.

Senator CHAFEE. I know, but did any of the other States have it? How many other States had it?

Mr. MENTZ. At the time the Worldwide Unitary Taxation Working Group started, there were 12 States.

Senator CHAFEE. Oh, I see.

Mr. MENTZ. So, we are down to three, and obviously, the most significant progress is California. So, our position, Mr. Chairman, is that congressional action on S. 1974 should be deferred until the remaining worldwide unitary States have a full opportunity to act. California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the operation of water's edge legislation in the States that have gone to the water's edge.

We don't think a treaty solution is the right answer. We think that is inappropriate because it only provides a resolution for foreign-based multinationals, not domestic. And since we have advocated broader Federal support of State tax collection activities, we would propose to go forward with that. And to the extent that the legislation, S. 1974, embodies provisions—the so-called spreadsheet provisions—that would assist States, we recommend that that legislation be enacted as soon as practicable, which probably means the next Congress.

Rather than go into any further details of my testimony, let me just say that there are really three problems that concern us with respect to California.

First of all, the election fee. The California legislation requires an election fee of the greater of 0.01 percent of the taxpayer's current year property, payroll, and sales or 0.03 percent of the value of 1986 property, payroll, and current year sales. That is a fee, Mr. Chairman, that must be paid in order that a taxpayer can elect water's edge unitary.

The position of the administration is that a taxpayer ought to be entitled to water's edge unitary without the payment of an election fee, or at least not a significant election fee. California has come a long way. The election fee is significantly reduced from the original election fee that was quite a bit larger. Nevertheless, 0.03 percent is not insubstantial.

A second point is regarding the so-called 80/20 issue. These are U.S. corporations that conduct most or all of their business in foreign jurisdictions. California treats those companies as within the water's edge. The Federal legislation would treat them as without the water's edge, that is outside of permissible combinations of water's edge unitary. The one exception in the Federal model is that a corporation doing business in Puerto Rico is within the water's edge; paradoxically, it is outside the water's edge in California's legislation. Putting possessions' corporations aside, I think that California is on the wrong track where it takes 80/20 corporations and brings them inside the water's edge.

On foreign dividends, California is close on foreign dividends. It provides a dividends received deduction of 75 percent; however, it is tied to the relative amount of payroll outside the United States and inside the United States. We don't think it should be tied to payroll; we think it should be an absolute exclusion. Seventy-five percent is probably close enough to the Federal model of 85 percent. It is principally these three aspects of California that would cause us problems.

Let me just conclude, Mr. Chairman, by restating that because of the recent enactment of State legislation on the unitary issue, we do not recommend adoption of restrictive Federal legislation at this time. We believe further progress is required to address the concerns we have raised; and if such progress is not forthcoming within a reasonable timeframe, we may recommend reconsideration of the legislation in the future.

Our goal is the elimination of the mandated use of the worldwide unitary method of taxation. We continue to support the portions of the legislation that provide assistance to States in implementing the separate accounting method. Mr. Chairman, I would be pleased to answer your questions.

Senator **Chafee**. All right. Now, Mr. Mentz, as I understand what you are saying, you don't want us to do anything now. You want these States to have what you call a full opportunity to act. Haven't they had a full opportunity to act previously? And what makes you think that some more time is a fuller opportunity?

Mr. **Mentz**. They have had a full opportunity to act, and I think the actions have been very significant. We have nine States that have gone to a water's edge approach, including California which, many people thought, California would never get there. And I think Senator Baucus was exactly right when he congratulated Senator Wilson. I think the Federal initiative on this has played a major role in achieving the movement that we have seen.

Senator **Chafee**. We haven't "cowed" Montana or Alaska or North Dakota.

Mr. **Mentz**. I think we are getting close. Some of those States do not have legislative sessions every year; and I think there are indications that we are moving in the right direction there. But also, I think California——

Senator **Chafee**. I have a lot of respect for the State government legislators, but I suspect one person from Sony talking to them is probably as strong an influence as any suggested movement by the Federal Government.

Mr. **Mentz**. I think you are completely correct there. There was a very substantial initiative on the part of the private sector to get California to move, and I think that was also a contributing factor.

Senator **Chafee**. But I thought you said that you didn't want us to move on Senator Wilson's entire bill. I thought you said something about proceeding with the accounting provisions.

Mr. **Mentz**. I think so. They are called the spreadsheet provisions, and would provide that more information be filed with the Federal Government by international corporations. And that information would be available to the States. That would be beneficial.

Senator **Chafee**. Does that require legislation?

Mr. **Mentz**. Yes.

Senator **Chafee**. Let me ask you another question. As I understand it, some of these companies that indeed do 80 percent or more of their business overseas keep their U.S. corporation cover, if you will, or operate through the U.S. corporation because of their efforts to protect their trademark. Is that correct?

Mr. **Mentz**. I think that may be true in some cases, yes.

Senator **Chafee**. Yes. All right. Let me ask you your thoughts. We are very anxious in the Congress, and I think especially in the Senate and especially in this committee, to do all we can to increase our assistance in the competitive position of U.S. corporations. Do you find this diminishing that competitive position or harmful to it?

Mr. **Mentz**. Do you mean the——

Senator **Chafee**. The fact that some States have a unitary tax; or put it the other way around, that we have not outlawed them, as it were?

Mr. **Mentz**. Oh, yes, absolutely. That has certainly been the administration's position. Secretary Baker has articulated that in letters; so has Secretary Shultz. I think there is no question that the worldwide unitary method has had an adverse effect both on the ability of the United States to attract business and also for U.S. companies with international business to be competitive.

Senator **Chafee**. Could you touch on that final thought?

Mr. **Mentz**. Yes.

Senator **Chafee**. The capability of the U.S. corporations to be competitive; why is that harmed because Alaska has a unitary tax?

Mr. **Mentz**. It is harmed because—well, let's take California before 1988. For a U.S. company that has foreign operations, both the worldwide unitary method and their—what we regard as—inequitable treatment of foreign dividends puts them in a position where there is a greater chance of international double taxation because this method of taxation has a tendency to doubly tax income that has already been taxed on a separate accounting method by some other country. For a corporation that is incorporated in Germany, for example, that doesn't have that method, they are not going to have the double taxation potential that a U.S. company doing business in California would. So, we do regard it as a factor that lessens the competitiveness; it is not as significant as exchange fluctuations, just to put it in perspective, but it nevertheless is a factor.

Senator **Chafee**. I think our approach—at least my approach—is that I don't think we are going to find one single thing that we can tie to to say "Eureka," that is going to solve our international competitive position. I think our international competitive position is made up of 15 different items.

Mr. **Mentz**. I agree with that.

Senator **Chafee**. And against every single one of them, the argument can be made, as it is made, say, against making drastic changes in our Foreign Corrupt Practices Act. Oh, it doesn't make that much difference. True, it doesn't make that much difference, nor does this, nor does a whole series of other things; but it just seems to me that our approach has got to be to take every little thing we can do and change it so that we can help this competitive position.

Mr. **Mentz**. I totally agree with that.

Senator **Chafee**. Senator Baucus?

Senator **Baucus**. Thank you, Mr. Chairman. Secretary Mentz, I very much agree with the comments you made and the chairman made about the degree to which worldwide unitary does adversely affect the U.S. competitive position. I think it is true; and I also firmly agree that the list of items that we have to pursue and actions we have to take are endless. It is either infinite impotent or it is one. The one is either attitudinal or cultural.

The United States is either going to compete or not going to compete. That basically comes down to the U.S. culture and what it means to be an American these days.

I think that worldwide unitary should be repealed in the remaining three States. I, however, think that due to the Supreme Court decision and other reasons that I have already indicated that that is basically up to the States to decide, whether they want to go ahead and repeal or not.

Do you know yet what the British reaction is to the California decision?

Mr. **Mentz**. The British Government issued a statement shortly after the California action in which it praised it as a major step forward and indicated that it was the general belief that it was very much progress in the right direction. Certainly, the tone of the statement, I would say, was inconsistent with a retaliation, January 1, 1987. They have not stated what their position would be on the retaliatory legislation, but I would be very surprised if their attitude was not very similar to our attitude, which is, that this is a major step forward; let's wait and see if the other three States are taken care of and if these other points are favorably resolved in California. If that all works out, I think the unitary problem will go away.

Senator BAUCUS. Is the administration pressing the United Kingdom for an answer or a position?

Mr. MENTZ. No.

Senator BAUCUS. When do you expect to receive one?

Mr. MENTZ. Within a short timeframe; a couple of weeks probably.

Senator BAUCUS. All right. Are there other countries besides the United Kingdom which have enacted retaliatory legislation?

Mr. MENTZ. No, not that I am aware of. Other countries have expressed serious concern. We have had concern expressed by Japan, Canada, Germany, France, The Netherlands. In fact, The Netherlands has expressed a reluctance to continue treaty negotiations until worldwide unitary is resolved. So, we get the pressures of worldwide unitary coming at us in various different ways; but I think this action in California greatly relieved those pressures, maybe not completely but to a large extent.

Senator BAUCUS. Thank you.

Senator CHAFEE. Since the California action does not take effect until, as I understand it, January 1, 1988, too, it is not complete. It is three-quarters, I suppose; but I should think somebody like the Shell Co. headquartered in The Netherlands would be very upset over this and thus the Netherlands Government upset over the unitary tax system.

Mr. MENTZ. The Netherlands Government certainly is, but I think most companies—I am not sure what the position of Shell is—but most companies regard the California solution very much as we do—as not perfect, with its flaws—but nevertheless a major step forward.

Senator CHAFEE. Senator Wilson.

Senator WILSON. I have a question that I think Secretary Mentz can amplify a little bit. In addition to the nine States that continued to retain the unitary method at the time the working group got under way, was there not a far greater number that briefly flirted with the idea and, in fact, went further and embraced the unitary method and then repealed it? At one point, it seems to me that it got up to pretty close to half. Florida, as I recall, was a State that had it, if I am not mistaken, and quickly learned the error of its ways and then rescinded the action. It is not important, but it goes to your question, Mr. Chairman, as to the extent of the problem. At one point, this was like a real contagion sweeping the land.

Mr. MENTZ. I can get you the number, Senator Wilson. Just to amplify that point, I would say it is not just the worldwide unitary method that is a problem here. It is also the taxation of foreign dividends because, for a U.S. company that has foreign subsidiaries, even if that State is not on a worldwide unitary method, if the dividends of the earnings are taxed fully in the jurisdiction where the profits are generated and then they are taxed again when repatriated to the U.S. parent, it will be an effect of double taxation similar to the results that would be attained under worldwide unitary.

So, progress in that respect is also welcome and has been occurring. So, I think we are seeing sort of the end results of a long campaign here that Senator Mathias really sort of started 20 years ago; and I think we are starting to see the fruition of the results.

Senator **Chafee**. What bothers me a little bit—I remember when this was spreading; I remember just as Senator Wilson that it lopped against the shores of our State, and our Governor achieved some renown with international corporations by saying that he would guarantee we wouldn't have it in our State, and I think the legislature supported him. So, that was a plus.

But what bothers me is that we may get a series of repeals but not total repeals; and vestiges of it will remain as apparently it has in California. Now, Senator Wilson, as I understood what you were saying, you are hopeful that those remaining parts will be eliminated likewise. Is there much hope for that?

Senator **Wilson**. I think there is substantial pressure for them to be eliminated from California-based corporations who feel, Mr. Chairman, that they had a comparative and competitive disadvantage with some of their most active competitors who are foreign based. So, I would say that there is substantial pressure upon California to go further than they have. On the other hand, for many, many years, there was substantial pressure upon them to take even the first step. And the problem is that they got hooked. The revenues increased markedly over the years, and I won't accuse any State official of being greedy because, of course, it is not his money, it is the public's money; but what happens frankly is that they were seduced by the easy source of income, much easier to tax those beyond your borders and particularly activity beyond your borders than to tax your own taxpayers. And they were not only seduced but, in contrast to most other seductions, the magnitude grew enormously.

Senator **Chafee**. Well, let's not pursue the analogy too far—— [Laughter.]

Let me just say that——

Senator **Wilson**. I thought seduction was a politer word than the one I have heard most people use. [Laughter.]

Senator **Chafee**. I would assume that, as a result of the changes that California has already made, probably the major source of the revenue has now been lost, and the remaining part is far less or less significant certainly in the total California budget. So, maybe there is a chance of achieving those repeals elsewhere.

Senator **Wilson**. Yes.

Mr. **Mentz**. Mr. Chairman, just to elaborate on that same point, there is a report required under the California legislation on this 80/20 issue. I believe it is due in March of 1987. So, before the California legislation becomes effective, there will be this report in which, I would expect, there would be pressure to change the 80/20 provisions. And also, I would reiterate what I said before that if these points are not cleaned up—either in California or the three other States—am fully serious in representing the administration's intention to bring the Federal legislation back if need be. So, I believe that is kind of a healthy curb on potential inaction by the States.

Senator **Chafee**. All right, fine. Thank you, Mr. Mentz. Senator Baucus.

Senator **Baucus**. Before Secretary Mentz leaves, I have here a letter which is, if nothing else, an interesting historical footnote. It is addressed to a Member of Congress, and it concerns legislation on the ability of States to tax certain items. The letter in part reads:

> Federal intervention in State tax matters is objectionable in principle.

And it goes on and says:

> The solutions of the legitimate problems of interstate tax should lie in uniformity rather than in the preferential exclusion to multistate businesses from State taxation. Several States, including California, are working on these problems, and considerable progress has been made.

I bring this up to show the consistency of the author, who not only made that statement but basically takes that same position here with regard to the unitary tax—that the State of California is working on it; this letter is signed by Ronald Reagan, the Governor of California, in 1967.

Senator **Chafee**. A historical footnote.

Senator **Baucus**. Right. I will leave it at that.

Senator **Chafee**. All right. Let's proceed. The next panel is Mr. Hurston, assistant vice president and director of tax administration, The Coca-Cola Co. of Atlanta, GA; John D. LaFaver, director of the department of revenue of the State of Montana; Thomas H. Boggs, counsel, Unitary Tax Campaign; and Jere W. Glover, general counsel, the National Small Business Association.

So, gentlemen, if you will take your seats, and we will have to enforce the 5-minute rule. It is my intention to complete these hearings by 11:30.

Senator **Wilson**. Mr. Chairman, before this panel of witnesses begins, if I may just make one point, mindful of the time? Title III of S. 1974, the so-called spreadsheet legislation, really is important to the States if we are going to ask them to forebear from this revenue source or this method of sourcing income to be taxed. They are entitled, we have established, to tax on some reasonable basis; and the information that they need in order to legitimately tax really is unavailable to many of them. It is unavailable, I am sure, to the smaller States; it is unavailable to a State as large as California and one which, like California, has vigorously sought to tax.

The Franchises and Tax Board has offices in New York City. I don't know where else, but nonetheless, it is only the Internal Revenue Service that really has access to information of the kind that they will require in order to be provided an alternative of the kind that we are hoping they will assume.

Senator **Chafee**. So, the solution to that, what you are suggesting, is what Mr. Mentz said about the accounting provision?

Senator **Wilson**. Absolutely.

Senator **Chafee**. All right, fine. Thank you. Mr. Hurston, why don't you proceed for Coca-Cola?

[The prepared written statement of Mr. Mentz follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EST
Monday, September 29, 1986

STATEMENT OF THE HONORABLE
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF TREASURY
TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for this opportunity to present the views of the Department of the Treasury on S. 1974, a bill introduced by Senator Pete Wilson that addresses state taxation of the worldwide income of corporations and their affiliates. In general, S. 1974 would prohibit states from levying corporate income taxes on a worldwide unitary basis, would require states to tax foreign source dividends in an equitable manner, and would provide additional federal assistance to the states for the administration and enforcement of their corporate income taxes. As you know, this legislation was drafted by the Treasury

Department at the express direction of the President and was introduced last December with the full support of the Administration. Identical legislation was introduced in the House of Representatives as H.R. 3980.

I am pleased to report that, since the introduction of the legislation, Idaho, New Hampshire, Utah and, on September 5, California, have enacted "water's edge" legislation. The Administration applauds these states' actions. These state legislative developments go a long way toward resolving the difficult unitary tax issue. Moreover, they illustrate the successful operation of the Federal system. These and the other states that have moved away from the worldwide unitary tax system in recent years recognize that their interest, and the national interest, lies in a single, coherent approach to taxing international income that minimizes tax-related impediments to international flows of investment capital.

We have not, however, reached the end of the road with respect to this issue. Though the economic impact is not great, three states (Alaska, Montana, and North Dakota) continue to impose tax on a worldwide unitary basis. As I will discuss below, we also have concerns regarding elements of the California legislation. We believe, however, that such significant progress has been made that restrictive Federal legislation is not warranted at this time. Rather, we believe that Congressional action on S. 1974 should be deferred until the remaining worldwide unitary states have a full opportunity to act, California has an opportunity to consider and respond to comments on its recently enacted legislation, and we have an opportunity to evaluate the actual operation of water's edge legislation passed by the several states when fully in effect.

We also do not believe that a treaty resolution of the unitary issue is necessary or appropriate at this time. Because a treaty would offer relief from worldwide unitary tax to foreign based multinationals while not addressing the inclusion of foreign dividends to domestic multinationals, a treaty resolution does not by itself satisfy the principle of ensuring competitive balance among similarly situated businesses. We therefore view a treaty approach to the issue as the least desirable of possible alternatives.

While we do not believe that restrictive federal legislation is called for at this time, the Administration has advocated broader federal support of state tax collection activities. States have moved away from the worldwide unitary method in part in reliance on the Administration's representations in this regard. To the extent possible without legislation, the Administration has already moved to provide greater assistance to the states. We continue to be committed to providing such federal support and believe that the portions of S. 1974 that are directed to that objective should be enacted at the earliest practicable time.

The progress made on this difficult issue is a tribute to the wisdom of President Reagan's decision in 1983 to seek a cooperative solution by convening a Worldwide Unitary Taxation Working Group, consisting of representatives from states, business and the Federal government, to address the issue. It is also a tribute to the leadership evidenced by the state officials and leaders of domestic and foreign-controlled multinationals that have together forged compromises in states across the country. We expect that these participants will continue to demonstrate the same leadership as we attempt to address the remaining concerns relating to the worldwide unitary tax issue.

In the remainder of my testimony I will discuss the background of the worldwide unitary issue, the proposed Federal solution, and concerns raised by the California legislation.

I. BACKGROUND

A. Separate Accounting Versus Worldwide Unitary Combination

The operation of a business enterprise across state or national boundaries requires each jurisdiction to determine what portion of the enterprise's income it will tax. The objective of each taxing jurisdiction should be to attribute to itself an amount of the income of the multijurisdictional enterprise that is appropriate in relation to the economic activity conducted in that jurisdiction. Failure of any of the taxing jurisdictions to assign the income to the respective jurisdictions of operation under a consistent accounting method may result in over-taxation (allocation of some income to more than one jurisdiction) or under-taxation (failure to allocate some income to any jurisdiction) of the enterprise's income. Two fundamentally different accounting methods may used for assigning or apportioning the income of a multicorporate enterprise: (1) separate accounting; and (2) formula apportionment based on unitary combination.

1. Separate Accounting - The longstanding policy of the federal government has been to require the use of the separate accounting method to allocate the income of a multicorporate enterprise among the national jurisdictions in which it operates. Under this method, taxable income is determined separately for each individual corporation in a multinational enterprise, and each corporate entity of the multicorporate enterprise is then separately subject to tax. Possible income-shifting between related corporations for tax avoidance purposes is controlled by requiring "arm's length" pricing for all transactions with related parties. That is, flows of goods and services between related or commonly owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length.

The separate accounting method is the accepted international standard for determining the multinational corporate income to be assigned to each taxing jurisdiction. This standard underlies our treaty relationships with other countries and is virtually universally applied around the world. The separate accounting method, when properly applied, produces a reasonable allocation of income among related entities and thus results in equitable tax consequences where more than one tax jurisdiction may have a claim to tax the income of a multinational enterprise.

2. Worldwide Unitary - To understand the worldwide unitary method, it is first necessary to understand the formula apportionment method used by all of the states that impose a corporate income tax. When a state imposes an income tax on business income, it may constitutionally tax only that income arising from or attributable to activities conducted within its geographic territory. Because of this limitation, all forty-five states that levy corporate income taxes determine their share of the taxable income of a single corporation that operates in several states by means of apportionment formulas based on business activity. Under this formula apportionment approach, if a single corporation operates in several states, the taxing state attributes or apportions a portion of the corporation's income to its jurisdiction on the basis of relative levels of business activity.*

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* If, for example, 10 percent of the corporation's total business activity (generally measured by payroll, property, and sales) is determined by a particular state's apportionment formula to occur within that state, then 10 percent of the corporation's total income will be subject to that state's corporate income tax.

Approximately one-half of the states that impose corporate income taxes also use the formula apportionment method to determine their share of the income of a multicorporate business enterprise conducting business in several jurisdictions through affiliated corporations. These states first require that income of affiliated corporations engaged in the same line of business and operating under common management and control (i.e., engaged in a "unitary business") be combined. Their apportionment formula is then applied to the income of the combined unitary business in order to determine the total taxable income of the affiliates attributable to their jurisdiction. After the recent legislative actions become effective, all but three of the states will limit the scope of the unitary combination to those corporations engaged in business activities within the boundaries of the United States, that is, within the "water's edge".

Under the worldwide unitary method of taxation that is the subject of the controversy, the total income of all individual companies in the global unitary business is aggregated, (i) regardless of whether the affiliated corporations are foreign or domestic; (ii) regardless of whether an affiliate has a tax nexus with or presence within the state in question; and (iii) regardless of whether the income of the other affiliates would be treated as derived from foreign or domestic sources under federal tax rules or generally accepted principles of international taxation. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of an apportionment formula that reflects relative levels of business activity inside and outside the state.

In an environment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. This risk exists because formula apportionment assumes that the business activity of a unitary business is equally profitable in all jurisdictions, whereas separate accounting assumes that individual corporations operating under different market conditions can earn different rates of return. Indeed, if other taxing jurisdictions consistently apply separate accounting principles, while a state applies the worldwide unitary method, double taxation generally will result in each case in which the relative profitability of the investment in the unitary tax state is less than that of the affiliated out-of-state operations.

Because of this potential for double taxation, foreign governments and multinational businesses have strenuously objected to state use of the worldwide unitary method. As a result of the application of the worldwide unitary method, our international economic relationships have been adversely affected and foreign investment in the United States may have been discouraged.

B. History Of The Unitary Issue

Foreign objections to the unitary method of taxation first became an important policy issue in the early 1970's. The United Kingdom strongly expressed its objections to state unitary taxation at that time in the course of negotiations to revise the U.S.-U.K. treaty. When the renegotiated U.S.-U.K. income tax treaty was originally submitted to the Senate for ratification in 1976, it contained a provision, Article 9(4), that would have excluded British parents of U.S. subsidiaries from unitary combinations when the parents themselves were not doing business in the United States. Opponents of the provision prevented ratification of the treaty with the unitary tax provision. Although there was strong sentiment in the U.K. for not ratifying the treaty without Article 9(4), further negotiations led to ratification of the treaty without a unitary provision.

After the removal of Article 9(4), opponents of unitary taxation turned to the judiciary to seek resolution of the issue. In 1983, however, the U.S. Supreme Court upheld the constitutionality of California's use of the worldwide unitary method of taxation as applied to a domestic-based multinational in Container Corporation of America v. Franchise Tax Board, 463 U.S. 159 (1983).

Following the Supreme Court decision in the Container Corporation case, the President directed that Treasury Secretary Regan establish the Worldwide Unitary Taxation Working Group, which was "charged with producing recommendations ... that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." Thereafter, the Worldwide Unitary Taxation Working Group met over a nine month period and, with Treasury Department guidance, ultimately arrived at a framework within which the unitary controversy could be resolved.

The Final Report of the Worldwide Unitary Taxation Working Group, issued August 31, 1984, recommended that states should follow three principles in developing specific state legislative measures to address the unitary issue:

Principle 1: "Water's edge" unitary combination for both U.S.-and foreign-based companies.

Principle 2: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle 3: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

The Report also outlined a set of guidelines to be used in implementing the three principles. The guidelines defined a "water's edge" limitation, listed limited permissible circumstances under which states could apply the worldwide unitary tax method for tax enforcement purposes, listed legal and procedural requirements which states could enact to ensure full disclosure and maximum accountability, and recommended specific Federal legislative and administrative measures to assist the states in administration and enforcement of their corporate income taxes.

In response to the Working Group recommendations four states, Florida, Indiana, Oregon and Colorado, acted promptly to adopt acceptable water's edge legislation. Other states, however, moved more slowly. In particular, in 1985 the California legislature considered, but failed to adopt, legislation that would have limited that state's use of the worldwide unitary system of taxation.

Continued inaction by these states on the unitary issue after the Working Group deliberations resulted in even stronger foreign protests. Most seriously, in July 1985 the U.K. Parliament unanimously adopted Section 54, in its 1985 Finance Bill. This provision permits the U.K. government to deny, on a unilateral and retroactive basis, the valuable Advance Corporation Tax refund benefit granted by the U.S.-U.K. bilateral tax treaty to U.S. corporations that own British subsidiaries. Although the U.K. has not yet invoked Section 54, the very existence of that provision and the possibility of its retroactive implementation has had a detrimental impact on the willingness of U.S. companies to repatriate earnings from their U.K. subsidiaries in accordance with the treaty provisions as well as a detrimental impact on commercial relations between the United States and the United Kingdom.*

By the fall of 1985, the seven remaining worldwide unitary states were having serious difficulties in implementing water's edge limitations consistent with the Working Group's recommendations. Foreign protests were becoming more and more heated in view of the apparent inability of the states to resolve the issue and, because of the British Government's authority to take retroactive retaliatory measures, U.S. corporations were facing the possibility of confiscatory penalties if they repatriated the earnings of their U.K. subsidiaries. As a result of these circumstances, on November 8, 1985, the President issued a statement supporting "legislation that would effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States" and instructed the Secretary of the Treasury to draft federal legislation incorporating this water's edge limitation on the use of unitary combination into law. The President further instructed the Secretary of the Treasury to pursue enactment of "domestic spreadsheet" legislation, designed to improve the workability and enforcement of state corporate income tax laws. The President's statement also instructed "the Attorney General to ensure that the United States' interests are represented in appropriate controversies and cases consistent with this [water's edge] approach".

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* The Treasury Department has serious concerns regarding Section 54. We believe that its existence is inconsistent with the U.S.-U.K. bilateral income tax treaty to the extent its threatened use causes U.S. taxpayers to refrain from claiming benefits under the treaty. Its actual implementation would be a clear violation of the treaty.

Our major trading partners responded favorably to the President's statement. The United Kingdom released a concurrent statement agreeing to defer considering implementation of Section 54 while the federal legislation was being enacted and in any event not to impose the retaliation prior to January 1, 1987.

In accordance with the President's directive, S. 1974 was drafted by Treasury. This legislation was introduced, on December 18, 1985 by Senator Wilson (co-sponsored by Senators Mathias and Hawkins). A companion bill, H.R. 3980, was introduced in the House by Representative Duncan.

In concert with the introduction of the legislation and in accordance with the President's November 8 statement, the Administration has continued to press for resolution of the unitary issue under the principles articulated in the legislation. Secretary Baker sent letters to the President of the Senate, the Speaker of the House, the Chairman of the Senate Finance Committee, and the Chairman of the House Ways and Means Committee; Secretary of State Shultz sent letters to the governors of six worldwide unitary states; and the Justice Department filed amicus curiae briefs in the pending Alcan Aluminum and Barclays Bank cases. A common theme throughout these Administration statements is that the ability of the United States to conduct foreign economic policy is impaired by the states' use of the worldwide unitary method.

As a direct result of these continuing initiatives, other state legislatures have taken action to limit or eliminate the use of the worldwide unitary system of taxation. Idaho, New Hampshire, Utah and most recently California have taken such action since the introduction of this legislation. We are very pleased that so many states have responded to the federal initiative and limited their use of unitary combination to the water's edge.

II. Overview of S. 1974

In general terms, S. 1974 would, except under special circumstances, impose a water's edge limitation on states' use of the unitary combination method; would require equitable taxation of foreign dividends at the state level; would require most multijurisdictional enterprises to file a domestic disclosure spreadsheet; and would broaden the IRS's ability to disclose corporate tax return information to the states.

A. Water's Edge Limitation

S. 1974 would impose a water's edge limitation on states' use of the unitary combination method of taxation. Limited exceptions would provide for those cases in which a taxpayer's material noncompliance with state or Federal law is such as to obstruct a state in its application of the water's edge limitation.

Proposed Code Section 7518(c) defines the water's edge limitation. In general, states would be prohibited from including in unitary combinations those corporations, both domestic and foreign, which conduct 80 percent or more of their business activity outside the United States and which have less than $10 million of business activity within the United States. Because the basis for this threshold limitation is U.S. business activity, we believe that incorporation as a domestic or foreign corporation should be irrelevant for purposes of applying the water's edge limitation. Accordingly, as a matter of fairness we believe it is appropriate to subject U.S. corporations to the same test and thus to exclude them from the unitary combination if they fail to exceed this threshold of U.S. business activity.

The water's edge limitation would not apply to certain corporations that have significant economic ties to corporations included within the water's edge but are not subject to substantial foreign taxes on their net income. This provision is intended to prevent corporations from sheltering income from state taxation by artificially shifting it through shell operations in tax haven countries. Further exceptions to the water's edge definition are provided so that states are not forced to recognize the federal tax incentives provided to certain types of corporations such as Foreign Sales Corporations and Section 936 corporations operating in Puerto Rico and other U.S. possessions.

The legislation specifically allows states to offer taxpayers an unconditional election to be taxed on a worldwide unitary combination basis.

B. Foreign Dividends

Under the unitary combination method, intercompany income flows within the unitary business, such as dividends, are eliminated in order to avoid the double counting of income. When the foreign components of a unitary business are not included in the unitary combination, the proper tax treatment of income repatriated from such foreign affiliates to the members of the water's edge unitary combination must be addressed in order that state taxing practices not discriminate against domestic-based multinationals in favor of foreign-based multinationals and strictly domestic enterprises. Accordingly, the legislation requires that foreign source dividends be subject to equitable taxation.

The legislation suggests certain alternative guidelines that states could follow in satisfying this standard of equitable taxation. Generally, these guidelines require that recognition be given either to the excluded business activity factors of the foreign payor corporation or to the foreign taxes already assessed against the payor corporation's income.

C. **Assistance To States**

1. Domestic Disclosure Spreadsheet - The Treasury Department endorses the Working Group recommendation that appropriate Federal assistance be provided to the states in order to assure proper working of the separate accounting method. The Working Group recommended that an annual information return be filed with the Internal Revenue Service by large multijurisdictional enterprises which would summarize the state tax filings of that enterprise. This return would also identify those related companies with which serious income shifting would be most likely to rise. In July 1985, Treasury released for comment draft legislation that would accomplish these objectives. Section 6039A of the bill under discussion today is based on this draft legislation, after taking into account the many comments received from affected business and the various states. We believe that the domestic disclosure spreadsheet is an integral and necessary part of the solution to the worldwide unitary problem.

2. Information Sharing with States and Common Agencies - The bill also contains provisions which would expand the exchange of information provisions currently contained in Section 6103 of the Code, dealing with (1) the exchange of treaty information, (2) the sharing of taxpayer information between states, and (3) the disclosure of IRS information to common agencies of the states.

The IRS now receives information about multinational taxpayers from foreign governments under exchange of information provisions in our tax treaties and other international agreements. Our treaties and information agreements, however, include confidentiality clauses which generally prohibit disclosure of treaty information to subnational jurisdictions. Amendments to these secrecy clauses would have to be negotiated. A number of our treaty partners have advised us that they would agree to appropriate extensions of the exchange of information provisions to facilitate elimination of states' use of the worldwide unitary method.

Under current provisions of Section 6103, a state may not disclose to another state any taxpayer information received from the IRS, and indeed may not even disclose that it has received information, even if the other state would be entitled to receive such information directly from the IRS. Thus, under current law, if a state obtains information from the IRS which indicates that a taxpayer is not complying with another state's law, it can do nothing to notify or otherwise assist that other state. The legislation would amend Section 6103 to provide that information relating to those corporations subject to the domestic disclosure spreadsheet could be shared between the states provided the states in question are independently entitled to such information.

Under current law, the IRS may disclose taxpayer information to an agency charged under the laws of a state with the administration of that state's tax laws. The Working Group recommended that if four or more states could designate a common agent to represent such states collectively in the administration of their corporate income tax laws, then such common agent should be afforded the same access to taxpayer information as is granted to an agent of any of the individual states. The legislation would grant agencies acting on behalf of several states access to information relating to those corporations subject to the domestic disclosure spreadsheet.

As discussed above, the Administration does not believe that enactment of federal legislation preventing state use of the worldwide unitary system is necessary at this time. However, the Administration continues to support the enactment of the portions of the legislation providing for the domestic disclosure spreadsheet and information sharing.

III. CALIFORNIA'S WATER'S EDGE LEGISLATION

Because of the size of California's economy and because of that state's history as an aggressive proponent of the worldwide unitary system of taxation, much of the recent controversy over the unitary issue has focused on California. On September 5, 1986, California Governor Deukmejian signed into law legislation (S.B. 85) that provides California corporate taxpayers with an alternative to the worldwide unitary combination method of taxation. Firms electing to use the alternative "water's edge" method would be able to exclude foreign affiliates from the unitary combinations upon which their taxable income is computed.

We welcome this very substantial positive step that California has taken in limiting its use of the unitary method of taxation to the water's edge. We do, however, have a number of serious policy concerns with the California legislation. Our primary concerns involve (1) the water's edge election fee of .03 percent of California property, payroll, and sales; (2) treatment of U.S. 80/20 corporations (other than possessions corporations) as within the water's edge; and (3) tying the 75 percent exclusion of foreign dividends to an employment factor.

A. Election Fee

The California legislation requires that the greater of .01 percent of the taxpayer's current year California property, payroll, and sales or .03 percent of the value of the taxpayer's California 1986 property, 1986 payroll, and current year sales after adjustments for new investment in California be paid annually as a water's edge election fee. The 1986 property and payroll bases upon which the .03 percent election fee is calculated can be reduced dollar for dollar by new investment in California.

In our view, a foreign corporation's ability to avoid being taxed by a state on its foreign income should not be conditioned on payment of a substantial election fee. In addition, the magnitude of the California election fee under the new legislation is such that the choice between water's edge and worldwide unitary may be significantly distorted, particularly for taxpayers with large existing investments in California property. We therefore view the election fee feature of the California legislation as a significant policy concern.

B. U.S. 80/20 Corporations

Under the California legislation, all U.S. corporations other than possessions corporations, even those which have more than 80 percent of their business activity outside the United States, would be subject to inclusion in water's edge unitary combinations. We believe that U.S. 80/20 corporations should be treated on a comparable basis with foreign corporations having less than 20 percent of their business activity in the United States. That is, when water's edge unitary combinations are defined on the basis of business activity, incorporation as a domestic should be irrelevant.

C. Foreign Dividends

The California legislation provides that 75 percent of foreign dividend income would be excluded from California corporate income. The percentage exclusion may increase or decrease if the taxpayer's United States employment increases or decreases relative to rest of world employment, but will not decrease below 75 percent so long as repatriated dividends are not more than those repatriated in any of three fixed base years.

Equitable resolution of the unitary tax controversy requires balance between domestic and foreign taxpayers. If a water's edge system were adopted without limitations on the ability of states to tax dividends received by U.S. companies from their foreign subsidiaries, domestic companies would be at a competitive disadvantage. S. 1974 required that foreign source dividends be taxed equitably. In the technical explanation of the bill, it was indicated that this requirement would be satisfied if 85 percent of foreign source dividends were exempted from state income tax. In itself, California's adoption of a 75 percent dividends received exclusion represents a relatively minor departure from the recommended 85 percent exclusion of foreign dividends contained in S. 1974. However, linkage of the exclusion percentage with payroll factors and base period repatriated dividends is questionable from a tax policy perspective and may, in some instances, substantially reduce the exclusion amount.

Because of these concerns, while we view the California legislation as a significant step in the right direction, we hope that California will revisit these issues.

We have similar concerns regarding the treatment of foreign dividends in the water's edge legislation passed in New Hampshire and Utah. In New Hampshire, foreign dividends are subject to customized apportionment formula as a separate source of income. This bifurcated treatment of foreign dividends is clearly inconsistent with the equitable dividend treatment standards of the federal legislation. In Utah, 50 percent of foreign dividends are exempt from tax, but the remaining 50 percent, along with a pro rata share of the payor corporation's business activity factors, is included in the unitary combination calculation.

IV. CONCLUSION

Because of the recent enactment of state legislation addressing the unitary problem, we do not recommend adoption of restrictive federal legislation at this time. We believe further progress is required to address the concerns we have raised and, if such progress is not forthcoming within a reasonable time frame, we may recommend reconsideration of the legislation in the future. We continue to support those portions of the legislation providing assistance to states in implementing the separate accounting method.

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STATEMENT OF DALLAS A. HURSTON, ASSISTANT VICE PRESIDENT AND DIRECTOR OF TAX ADMINISTRATION, THE COCA-COLA CO., ATLANTA, GA; AND CHAIRMAN, SUBCOMMITTEE ON FEDERAL LEGISLATION, COMMITTEE ON STATE TAXATION

Mr. HURSTON. Thank you, Senator. My name is Dallas Hurston, and I am director of tax administration for the Coca-Cola Co. I represent today the Committee on State Taxation, which is comprised of 250 of the largest corporations—certainly those that are most severly impacted by this problem. Needless to say, we are extremely disappointed that the Treasury is backing down on their desire for current legislation to solve the problem. We think that the situation has been put very well.

The discrimination against U.S. companies is enough reason by itself to enact legislation, and certainly the California bill does that. In taxing dividends of 80/20 companies the California bill definitely discriminates against U.S. companies. We have submitted in our presentation the points that we would like to see addressed including amendments to Senate bill 1974; but I would like to address one particular issue that has been discussed here, and that is the question of 80/20 companies, since my company—the Coca-Cola Co.—is a vivid example of why that issue discriminates against U.S. companies.

The Coca-Cola Co. has been doing business overseas since the turn of the century. We do business in 55 foreign countries and sell our products in 160 foreign countries.

Those activities have historically developed through what is known today as 80/20 companies. Probably the term was not even used at the time we expanded, but those activities were basically developed through branches of U.S. corporations. The expansion was done in a U.S. corporation to protect the company's trademarks and patents. The body of common law with regard to those assets and the protection of those assets was not well developed at the turn of the century; and therefore, to provide some protection to U.S. companies, an 80/20 or U.S. corporation was used.

Those corporations manufacture in the foreign country and sell in the foreign country. They do not export from the United States nor do they produce in the foreign country for import back into the United States. By necessity, to meet both local consumption needs, the company manufactures in the foreign country and sells in the foreign country.

Under the California approach—and that approach, by the way, of many other States, including some of the other States that have repealed and including some States that have never applied worldwide combinations—those 80/20 companies are discriminated against because they do not receive the same treatment as foreign incorporated corporations, and that clearly—clearly—is a situation that should be addressed.

The taxation of dividends also discriminates against U.S. corporations. The 80/20 issue is one that should be addressed by the Congress with regard to the States that apply it and the question that was raised by the Senator from Montana.

The Department of Revenue, in testifying before the State legislature in Montana, stated that they had never applied worldwide combination to a foreign corporation. That is a frightening thought—that they have statutes on the books that apply to concepts equally to everyone, and yet, say, Montana had never applied it to a foreign-based corporation. This is on record before the Department of Revenue within the last year.

That is the situation that U.S. companies have been faced with. That is the situation we are faced with in the repeal of worldwide combination without addressing dividends, without addressing the 80/20 issue. Thank you.

Senator CHAFEE. Now, wait a minute. Let me see if I understood what you said in the last part. You quoted the State of Montana, that they just tax U.S. corporations?

Mr. HURSTON. Worldwide combinations, and I think the gentleman who made the statement before the legislature is going to be on the panel. The testimony before the legislature was that Montana had never applied worldwide combination to a foreign-owned corporation. It was only applied to U.S. companies. Clearly, even the States that had applied it were discriminating against U.S. companies. That alone, it seems to me, is reason enough for the Congress to act and to prohibit States from discriminating.

Senator CHAFEE. What we will do is we will take each of the witnesses, and then we will get back to you.

Senator BAUCUS. Mr. Chairman?

Senator CHAFEE. Yes?

Senator BAUCUS. I would like to introduce the next witness, if I may?

Senator CHAFEE. Fine. Won't you, please?

Senator BAUCUS. He is the director of the Department of Revenue of the State of Montana. We are flattered, Mr. Chairman, to learn—particularly in view of the last comment—that Montana is such an important part of national policy. John LaFaver is presently the director of the department of revenue, as I said. He is also formerly the director of the department of rehabilitative services in our State. He is a very sharp guy, and I think you will find, as you listen to him, that he will more than adequately represent our State and probably address the questions that have just been raised. Thank you.

Senator CHAFEE. We are delighted. We are glad to have you, Mr. LaFaver. Why don't you proceed?

[The prepared written statement of Mr. Hurston follows:]

STATEMENT OF DALLAS A. HURSTON

To Senate Finance Subcommittee on Taxation & Debt Management

Re: S.1974, "Unitary Tax Repealer Act"

On Behalf of the Committee on State Taxation (COST)

of

The Council of State Chambers of Commerce

September 29, 1986

My name is Dallas Hurston. I am Assistant Vice President & Director of Tax Administration of The Coca-Cola Company. I appear here today as Chairman of the Federal Legislation Subcommittee of the Committee on State Taxation (COST) of the Council of State Chambers of Commerce. COST is composed of some 250 major corporations representing a very significant portion of the taxpayers concerned with this issue.

The basic problem is that this is an international issue that is clearly the responsibility of the Federal government. It cannot be resolved satisfactorily on a State-by-State basis.

FEDERAL LEGISLATION STILL REQUIRED
BECAUSE STATE ACTION DOES NOT RESOLVE PROBLEM

California Change Would Discriminate Against American Companies

Even though the number of States that still use Worldwide Combination has decreased from the 12 that the Treasury listed when the Worldwide Unitary Taxation Working Group was created in 1983 to 3 States, Federal legislation along the lines of S.1974 is still needed. As long as there are States practicing worldwide combination (Alaska, Montana & North Dakota) all of the arguments against this practice still hold. States action to limit worldwide combination is non-binding; therefore a State could reverse position at anytime.

In addition only Colorado, Florida, Idaho, and Massachusetts have changed laws so that they are in compliance with all the major provisions of S.1974. The legislation enacted by Oregon, Indiana, Utah, New Hampshire, and California is all seriously defective in some major respects.

The new California legislation is particularly objectionable because it not only discriminates against American companies in favor of their foreign competition in the way it would tax foreign source dividends, but also excludes major portions of American industry from any benefits of the bill.

FEDERAL RESTRICTIONS ON STATE TAXATION OF FOREIGN SOURCE DIVIDENDS ESSENTIAL

The California treatment of Foreign Source dividends, provided for in that State's new legislation, illustrates the continued need for Congressional action. Even if an American owned company is organized in a manner that permits it to benefit from filing the so-called "water's edge" combination, 25% of its foreign source dividends will still be taken into consideration in calculating the California tax. This will discriminate against American companies in favor of foreign competitors because in many cases foreign governments will not impose an equivalent tax on those competitors. Even the 25% exclusion will not be fully available to companies that increase foreign employment in order to compete in foreign markets.

Unlike Oregon, where the Governor and the Revenue Department agreed that the 15% of foreign source dividends included in the tax base would be in lieu of any interest offset, California will still impose an interest offset, although somewhat less onerous than their present procedures. Thus while still taking into consideration 25% of the American companies foreign source dividends, California will add to their discrimination against American companies by applying an interest offset.

The attached table indicates how the various States tax, or in most cases, do not tax foreign source dividends.

FEDERAL LEGISLATION NECESSARY TO ASSURE EQUITABLE TREATMENT OF AMERICAN 80/20 COMPANIES

The new California legislation also illustrates the need for Federal legislation to restrict States from not only discriminating against American companies in favor of foreign competitors, but from discriminating against some American companies in favor of other American companies. This situation results from California's exclusion of American incorporated companies from the benefits of a water's edge combination even though they have more than 80% of their operations overseas - the so-called 80/20 company under the Internal Revenue Code.

The Coca-Cola Company has operations in over 50 foreign countries which sell products in over 155 foreign countries. These overseas operations have been developed through an 80/20 corporation, The Coca-Cola Export Corporation. Even though it is a U.S. corporation and is headquartered in the United States, The Coca-Cola Export Corporation does 100 percent of its business outside of the United States, therefore qualifying as an 80/20 corporation. These foreign operations have grown virtually independent of The Coca-Cola Company's domestic operations, with only a nominal capital investment since its creation over 55 years ago.

The choice of an 80/20 corporation for our overseas operations was made purely on business reasons and not for tax reasons. In fact, taxes were not significant enough to be an issue at the time of the company's creation. The year was 1930, companies were beginning to expand overseas, and the vehicle of choice was a U.S.-based corporation to develop the overseas branch operations. An overriding concern to The Coca-Cola Company was the protection of its patents and trademarks. It was determined that the most protection would be from a separate U.S. corporation which would then establish branch operations abroad, and The Coca-Cola Export Corporation was formed.

The Coca-Cola Export Corporation manufactures its products in foreign countries for consumption in those foreign countries. The activities of this company are driven by local consumption demands, not the ability to produce in a foreign country for export to the United States. Therefore, the exclusion of 80/20's from the "water's-edge group" would not jeopardize U.S. jobs by causing an export of jobs to foreign countries.

AN EXAMPLE OF DISCRIMINATION

The following example illustrates the discrimination inherent with the inclusion of the 80/20 corporations in the "water's-edge group" by comparing the tax impact to The Coca-Cola Company of using an 80/20 company, a U.S. parent company using a foreign subsidiary, and a foreign parent company doing buisness in the United States. The Coca-Cola Company must include 100 percent of its foreign source income because the 80/20 corporation is included in the California "water's-edge" group, compared with the U.S. Parent with a foreign subsidiary which is taxed on only 25 percent of the dividends paid by the foreign subsidiary and the foreign parent corporation which is not taxed on any of its foreign operations.

	Coca-Cola Company With an 80/20 Corporation	U.S. Parent With Foreign Sub.	Foreign Parent With U.S. Operations in Separate Sub.
U.S. Income $100,000,000	$100,000,000	$100,000,000	$100,000,000
80/20 Foreign Income	10,000,000		
Dividends from Foreign Sub. with 75 percent exclusion		2,500	
Income Taxable in California	$110,000,000	$102,500,000	$100,000,000

NEED FOR TECHNICAL REVISIONS IN THE ADMINISTRATION'S BILL

Attached is an explanation of "technical" changes that are needed in S.1974 (Suggested language will be given to the Finance Committee staff in order to stay within the 30 page limit for the hearing record). These have been given to Treasury previously jointly by the Committee on State Taxation and the Unitary Tax Campaign. They include such matters as language to correct the interest offset problem.

The proposed change in the 80/20 language is intended to make certain that the bill would not encourage the "exportation" of jobs and purchases by American 80/20 companies. We are certain this was not the intent of the Administration, but the present 80/20 language in S.1974 would do precisely that.

CONCLUSION

I hope I have said enough to convince you that Federal legislation is necessary to prevent a small minority of the States from discriminating against American companies and workers in favor of their foreign competition, and in some cases even discriminating against American companies that are organized on an 80/20 basis.

The Administration proposal, S.1974 will do a very good job of treating both American and foreign companies fairly, if amended along the lines we have suggested.

We want to commend the Administration, the Treasury specifically for the hard effort they have contributed to resolving this matter and this Subcommittee for holding this hearing. The Committee on State Taxation and the staff of the Council of State Chambers stand ready to provide technical assistance and work with you in finally resolving this longstanding problem. This includes briefing the staff on a State-by-State basis since this is our area of expertise.

SUMMARY OF PROPOSED CHANGES TO S. 1974

1. Page 2, Lines 4-18.

This revision to sec. 7518(a) deletes all conditions to the prohibition of taxation on a worldwide unitary basis.

2. Page 2, Line 23.

The insertion of the adjective "apportioned" in sec. 7518(b) is intended to clarify that the applicable "income base" is the total unitary income base which a State apportions to its jurisdiction by applying factors (*e.g.*, property, payroll and sales). This clarification is continued on page 3, lines 3 and 5 and page 4, line 4. (See also Item 8.)

3. Page 3, Line 6.

This revision to sec. 7518(b)(1) clarifies that the 85 percent dividend exclusion will be permitted only if the exclusion is calculated without any attribution of expenses between the payor and recipient corporations which would adjust the amount of dividend.

4. Page 3, Lines 12 and 13.

As drafted, sec. 7518(b)(3) may permit a method of computing an "equitable portion" which produces an includable portion that is greater than the portions computed under subsections (b)(1) and (b)(2). The revision permits alternative methods only if the method adopted does not produce an equitable portion which is greater than the amounts that would be computed under subsections (b)(1) and (b)(2).

5. Page 3, Lines 15-17.

This revision deletes the exception to sec. 7518(b) for a State of commercial or legal domicile and assures that the principle of sec. 7518(b) applies to all dividends received from corporations located outside the water's edge, regardless of where the recipient corporation is legally or commercially domiciled.

6. Page 3, Line 19.

The addition of the words "or of any amount deemed a dividend under section 78" is intended explicitly to prevent States from including any of the sec. 78 "gross-up" in their tax base.

7. Page 3, Line 19.

This revision assures that income which is deemed a dividend for purposes of Subpart F will be subject to the rules of sec. 7518(b).

8. Page 4, Lines 4-5.

The insertion of the words "by reference to which the taxable income is determined" and the following deletion are intended to clarify further the original text's reference to "income base."

9. Page 4, Line 9.

The objective of this change is to place domestic corporations that make an election under sec. 936 outside the water's edge.

10. Page 4, Lines 16-25; Page 5, Lines 1-10; and Page 8, Line 3.

The revision to sec. 7518(c)(2)(D) and the insertion of a new section 7518(c)(7) on page 8 adopt a water's edge solution based on a "permanent establishment" concept. Under the revision, an entity's income would not be subject to worldwide unitary taxation unless the entity is engaged in a trade or business in the U.S. through a permanent establishment. The mark-up includes three options which would accomplish this revision.

11. Page 5, Line 22.

The original text of sec. 7518(c)(3)(B) provides that a corporation which "carries no substantial economic activity" may be treated as within the water's edge. This text could apply to a foreign parent which operates as a holding company. One of the purposes of the water's edge legislation is to assure that these foreign parents are not subject to taxation on a worldwide unitary basis. The proposed change limits application of the subsection only to foreign corporations which can be manipulated by corporations within the water's edge to avoid State and federal taxation.

12. Page 6, Line 7.

The revision assures that only transactions between a permanent establishment of a foreign corporation and another foreign corporation will be considered in determining whether to include a corporation within the water's edge under the provisions of sec. 7518(c)(3).

13. Page 6, Line 14.

The revision is intended to clarify that legitimate business operations conducted through foreign corporations will not be treated as within the water's edge. The insertion assures that the subsection will only apply to sham transactions, not legitimate operations.

14. Page 6, Lines 18-25 and Page 7, Lines 1-8.

The revision adopts the current Federal law definition of an "80/20" corporation as a means of determining when a domestic corporation shall be treated as outside the water's edge.

15. Page 7, Lines 12 and 24-25.

The revision clarifies that the Secretary may issue regulations providing that permanent establishments of other foreign corporations shall be treated as separate U.S. corporations for purposes of sec. 7518.

16. Page 8, Lines 21 and 24.

The revision assures that sec. 6039A(a) will not require reporting on corporations which are not controlled by more than 50 percent ownership by a "reporting corporation."

17. Page 9, Lines 3-5.

This deletion is intended to limit the discretion of the Secretary to expand the amount and type of information to be furnished under sec. 6039A.

18. Page 10, Lines 19-24.

The revision is intended to eliminate the possibility that a domestic corporation with no overseas operations will be required to report under sec. 6039A.

19. Page 13, Line 17.

This revision to sec. 6039A(d) clarifies that disclosure of the "spreadsheet" information may only be made to a "designated" agency (see Item 22).

20. Page 14, Line 24.

This new sec. 6039A(f) would exempt from the reporting requirements of sec. 6039A a taxpayer which elects to file on a worldwide unitary basis in every State.

21. Page 15, Line 20.

The insertion is intended to permit a State to use information disclosed under sec. 6039A only to implement the purposes of the Unitary Tax Repealer Act.

22. Pages 16-19.

As drafted, sec. 6103(d) would permit many different "common agencies" to have access to the spreadsheet information. The revisions contained in these pages are intended to limit information disclosure only to an agency designated to represent all states collectively in tax administration matters.

COMMITTEE ON STATE TAXATION
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STATES IMPOSING A WORLDWIDE COMBINED REPORTING SYSTEM
(at time of formation of Worldwide Unitary Taxation Working Group)

Alaska
California
Colorado
Florida
Idaho
Indiana
Massachusetts
Montana
New Hampshire
North Dakota
Oregon
Utah

STATES WHICH SUBSEQUENTLY REPEALED THE WORLDWIDE COMBINATION PRACTICE

Oregon	Repealed August 15, 1984, effective January 1, 1986
Massachusetts	Massachusetts Supreme Judicial Court ruled against State's administrative practice on December 11, 1984
Florida	Repealed December 20, 1984, effective September 1, 1984
Indiana	Repealed April 18, 1985, effective January 1, 1985
Colorado	Repealed June 12, 1985, effective January 1, 1986
Utah	Repealed March 17, 1986, effective January 1, 1986
Idaho	Repealed April 4, 1986, effective January 1, 1988
New Hampshire	Repealed, effective July 1, 1986
California	Revised September 5, 1986, effective January 1, 1988

STATES IN WHICH LEGISLATURE ADJOURNED WITHOUT REPEAL ACTION

Alaska
Montana
North Dakota

JAW/September 5, 1986

September 5, 1986

STATE TREATMENT OF FOREIGN-SOURCE DIVIDENDS
Jean A. Walker, Committee on State Taxation

	Exemption			Treatment of Balance		
	Exempt	Conditional	Partial	Allocate	Apportion	Statute(s)
ALABAMA				X		§§40-18-34,40-18-35(14), Reg. 810-3-31.02
ARIZONA	X					§43-1122(8), L. 1985, c. 109, eff. for taxable years beginning from/after 12-31-83
ARKANSAS		If 95% ownership of payor.			X	§84-2008(2)(j)
CALIFORNIA 1)					X	§§24271, 24402
2)		If more than 50% ownership of payor, 75% exclusion of base period dividends (greatest amount of dividends received in any one of 1984, 1985 or 1986 income years); exclusion of foreign dividends in excess of base period amount dependent upon increase or decrease in foreign payroll factor.			X	§24411, S.B. 85 as enacted, eff. for tax years beginning on/after 1-1-88
COLORADO			Amount of exclusion of all foreign-source income dependent upon election of federal foreign tax deduction or credit.		X	§39-22-304, §39-22-303(10), L. 1985, H. 1010, eff. for tax years beginning on/after 1-1-86
CONNECTICUT	X					§12-217(a)(D)
DELAWARE	X					§1903(a)(2)
FLORIDA	X					§220.13(1)(b)2.a, ch. 84-549, Laws of Florida, eff. for tax years beginning on/after 9-1-84
GEORGIA	X					§48-7-21(b)(9)
HAWAII					X	§235.7(c)
IDAHO 1)					X	§63-3022
2)			85% exclusion.		X	§63-3027C, L. 1986, c. 342 (HB 669), eff. for tax years beginning 1-1-88 or January 1 of year after Federal disclosure spreadsheet legislation adopted, whichever earlier
ILLINOIS		If 80% ownership of payor.	Otherwise, 85% exclusion.		X	§2-203(b)(2)(0), L. 1982, P.A. 82-1029, eff. for taxable years ending on/after 12-31-82
INDIANA					X	§6-3-1-3.5(b)
IOWA					X	§422-35
KANSAS					X	§79-32,138
KENTUCKY	X					§141.010(12)(b)
LOUISIANA				X		§§42.A, 63, 242(1)(d), 243.A(4)
MAINE					X	§5102.8
MARYLAND		If 50% ownership of payor.			X	§280A(c)(5)
MASSACHUSETTS (Unless less than 15% ownership of payor.)	X					§38(a)(1)
MINNESOTA	X					§290.21 Subd. 4(e), L. 1984, c. 502, eff. for taxable years beginning after 6-30-85

	Exemption			Treatment of Balance		
	Exempt	Conditional	Partial	Allocate	Apportion	Statute(s)
MISSISSIPPI					X	§§27-7-15(1), 27-7-15(4)(i), 27-7-23(c)(2)(B)
MISSOURI	X					§143.431, Union Electric Co. v. Coale, 347 Mo. 175 (1940)
NEBRASKA	X					§77-2716(7), L. 1984, LB 1124, eff. for taxable years beginning on/after 1-1-84
NEW HAMPSHIRE					X	§§77-A:3.II
NEW JERSEY		If 80% ownership of payor.	Otherwise, 50% exclusion.		X	§54:10A-4(k)(1)
NEW MEXICO					X	§§7-2A-2.M & N
NEW YORK		If 50% ownership of payor.	Otherwise, 50% exclusion.		X	§§208.9(a)(1) & (2) and (b)(2)
NORTH CAROLINA				X		§§105-130.7, 105-130.4(f)
OHIO	X					§5733.04(I)(2)
OKLAHOMA				X		§2358.A.4.b
OREGON			85% exclusion.		X	§317.267(2), c. 1, Oregon Laws 1984, eff. for tax years beginning on/after 1-1-86
PENNSYLVANIA	X					§§7401(3)1.(A) & (B)
RHODE ISLAND					X	§§44-11-11, 44-11-12
SOUTH CAROLINA 1)		If 80% ownership of payor.		X		§12-7-700(15) repealed L. 1985, S351, eff. for tax years begining after 12-31-84; §12-7-1120(2)
2)				X		§§12-7-415, 12-7-430 added L. 1985, S351, eff. for tax years beginning after 12-31-84; §12-7-1120(2)
TENNESSEE		If 80% ownership of payor.			X	§67-2704(b)(2)(A)
UTAH			50% exclusion.		X	§59-13-5(2)(d), L. 1986, c. 80 (HB 178), eff. for tax years beginning on/after 1-1-86
VERMONT					X	§5811(18)
VIRGINIA		If 50% ownership of payor.		X		§§58-151.032(g), 58-151-037
WEST VIRGINIA 1)	X					§11-24-6(c)(3) limited L. 1985, H1693, to taxable years beginning before 7-2-87
2)					X	§§11-24-6, 11-27-7(d)(3)
WISCONSIN		If 80% ownership of payor.			X	§71.04(4)
DISTRICT OF COLUMBIA					X	§47-1810.1
Worldwide Combination States*						
ALASKA					X	§43.20.065
MONTANA					X	§15-31-113(1)
NORTH DAKOTA					X	§57-38-01.20

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*Dividends between combined corporations are eliminated from income, thus the indicated treatment of dividends applies only to dividends received by members of the combined group from corporations not included in the combination.

STATE TREATMENT OF FOREIGN-SOURCE DIVIDENDS

Foreign-Source Dividends Totally Exempt (12)

Arizona
Connecticut
Delaware
Florida
Georgia
Kentucky
Minnesota
Missouri
Nebraska
Ohio
Pennsylvania
West Virginia

Foreign-Source Dividends Substantially Exempt (14)

Arkansas
California
Colorado
Idaho (1988)
Illinois
Maryland
Massachusetts
New Jersey
New York
Oregon
Tennessee
Utah
Virginia
Wisconsin

Foreign-Source Dividends Allocated to Commercial Domicile (5)

Alabama
Louisiana
North Carolina
Oklahoma
South Carolina

Foreign-Source Dividends Taxable and Apportionable (11)

Hawaii
Indiana
Iowa
Kansas
Maine
Mississippi
New Hampshire
New Mexico
Rhode Island
Vermont
District of Columbia

II. Worldwide Combination States (3)

Alaska
Montana
North Dakota

JAW/September 1986

STATEMENT OF JOHN D. LaFAVER, DIRECTOR, DEPARTMENT OF REVENUE, STATE OF MONTANA, HELENA, MT; AND CHAIRMAN, MULTISTATE TAX COMMISSION

Mr. LaFaver. Thank you, Mr. Chairman and Senator Baucus. I am John LaFaver, the director of the Montana Department of Revenue and chairman of the Multistate Tax Commission.

My opposition to S. 1974 and similar legislation can be summarized as follows. Federal intervention in State tax matters is objectionable in principle. Of course, those aren't my words; the Senator just read the letter. They were written in 1967 by the Governor of California, Ronald Reagan, in opposing Federal legislation similar to this. We in Montana hope the President's views are unchanged. Certainly, if the administration's New Federalism means anything, it must include allowing States to exercise the basic authority of setting State tax policy.

S. 1974 would carve what we feel are unwarranted and ill conceived loopholes in tax laws of 27 States. Multinational firms would enjoy a tax break of about $500 million per year. Hard-pressed States such as Montana and others would be forced to increase taxes on Main Street businesses and wage earners to pay for it.

It seems incongruous to those of us out in the sticks that a Congress which just this weekend passed a landmark tax reform package, lowering rates by eliminating a laundry list of special privileges, would seriously consider a bill like this, a bill that gives multinationals all the tools they need to minimize or avoid State taxation at the expense of the rest of us.

Finally, I would ask you to examine the work of the worldwide taxation working group. That effort of State and Federal officials and representatives of domestic and foreign multinational firms recommended broad-based reforms in unitary taxation in 1984. Fundamental to those recommendations was that they be considered as State tax policy, not jammed down the States' throats. And the record since—as we have talked about this morning—shows that a voluntary strategy has worked.

Of the original States applying full worldwide combination only three have not yet changed their laws. Of the three, Montana and North Dakota at least will propose unitary legislation in 1987. So, this bill simply aggravates a problem that is on its way to being resolved. The bill advocates an approach that the President himself on occasion has opposed. I would ask you to join in that opposition.

Thank you.

Senator **Chafee.** Thank you very much, Mr. LaFaver. Mr. Boggs.

[The prepared written statement of Mr. LaFaver follows:]

Multistate Tax Commission

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Statement of John D. LaFaver
Director, Montana Department of Revenue

Chairman,
Multistate Tax Commission

before the
Subcommittee on Taxation and Debt Management
U.S. Senate Committee on Finance

September 29, 1986

On behalf of the State of Montana and the other member states of the Multistate Tax Commission, I urge that the Subcommittee reject S. 1974 and any similar legislation which attempts to prohibit the states from using the worldwide unitary combination apportionment method of determining the taxable income of multinational corporations and restricts state taxation of dividends received by multinationals.

In summary, the State of Montana and the member states of the Multistate Tax Commission oppose S. 1974 and similar legislation because:

- It allows an unwarranted intrusion by the federal government into state tax policies.
- It violates the spirit and the letter of the Worldwide Unitary Taxation Working Group efforts to resolve disagreements between some states and multinational corporations.
- It goes beyond the usual concerns of unitary taxation to restrict the tax policies of 27 states regarding taxation of corporate dividends and certain domestic corporations.

We urge Congress to require the Treasury Department to immediately implement Secretary Regan's commitment of two years ago to provide federal assistance to the states in enforcing full disclosure by multinational firms. Without this critical element, the entire process of retreating from worldwide combination will simply result in shifting legitimate tax responsibilities of multinational firms to domestic corporations.

Mr. Chairman and Members of the Subcommittee:

I appear before you today to urge, on behalf of both my state of Montana and the other member states of the Multistate Tax Commission, that the Subcommittee reject S. 1974, which would prohibit the states from using the worldwide unitary combination apportionment method of determining the taxable income of multinational corporations and restrict state taxation of dividends received by multinationals, and any similar legislation which attempts to restrict the use of any constitutional method of taxation by the states. In this particular instance, the issue is the use of worldwide unitary combination, a method of applying the net corporate income tax at the state level. This approach, first developed in California nearly half a century ago, has been used by as many as twelve states at one time or another. Though some businesses have been upset with its use, the United States Supreme Court has, without exception, upheld the right of states to use this approach in determining state corporate income tax liability and has declared the approach "fair and proper."

Opponents of this approach, in part because of their inability to have their views upheld in the courts, have turned instead to Congress for relief. Legislation which attempts to restrict state use of worldwide combination has been filed regularly in Congress for two decades, and the Multistate Tax Commission has consistently opposed such legislation over that period. Whatever the arguments in favor of such restrictions, we believe that none of them are so profound as to be worth violating fundamental principles of American federalism. The views of the Commission, while officially limited to the nineteen states who compose it, are shared by virtually all groups representing state governments, including the National Conference of State Legislatures, the National Association of Tax Administrators, and the National Governors' Association. The U.S. Advisory Commission on Intergovernmental Relations, a prestigious bipartisan body devoted to the study and strengthening of American federalism, has stated its view unequivocally:

> It is clear that (a) our federal system allows the states the widest latitude in determining their own tax structures, (b) the judicial system provides processes for determining whether state tax practices conflict with constitutional standards, (c) business enterprises in our federal system are free to locate in states that provide the most congenial tax climate, and (d) there is no evidence that state tax practices cause harm to the nation. Therefore, the Commission recommends that the United States Congress pass no law that will limit state tax practices with respect to multinational corporations or "foreign source" income. ["State Taxation of Multinational Corporations," April 1983, Report A-92, p.

7.]

Our views could not be more precisely stated. But the Multistate Tax Commission does not, and has not in the past, attempted to limit its activities to merely opposing federal restrictions. Instead, through its joint audit program, development of model laws and regulations, and the work of its educational programs and publications, the Commission aims to demonstrate that it is possible to address the problems of multistate taxation in a cooperative manner and thereby alleviate some of the problems which gave rise to requests for federal restriction. Thus, the Commission has generally supported the superiority of voluntary interstate cooperation over federal restriction or mandates, and attempted to take an active part in implementing such cooperation.

The most recent such example came in 1983, when, following the Supreme Court's decision in the Container case (which unequivocally upheld the constitutionality of worldwide combination), the Administration was strongly pressured to support legislation restricting combination. Instead, the President authorized then-Treasury Secretary Donald Regan to establish a commission to study the issue. This led to the establishment of the Worldwide Unitary Taxation Working Group, whose report issued a year later suggested a voluntary approach to the problems allegedly caused by the state use of worldwide combination.

My predecessor as Chairman of this Commission, Kent Conrad (State Tax Commissioner of our neighbor, North Dakota), served on that Working Group along with other state officials, federal officials, and representatives of domestic and foreign multinational corporations. Fundamental to the participation by state representatives and the Multistate Tax Commission was that policy recommendations would go to the individual states for their consideration. The group eventually agreed that resolution of problems in this area rested on three principles:

1) Water's edge unitary combination for both U.S. and foreign-based companies;

2) Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and

3) Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

The key to success was to be in respecting state sovereignty, and not in heavy-handed attempts to override it. The record is clear: at the time the Working Group undertook its efforts, twelve states used worldwide combination. Today, only three -- Alaska, Montana and North Dakota -- have not fully receded from that position. I want to note, however, that my own state is not and never has been a full worldwide unitary state because we exclude foreign parent corporations from unitary accounting. That exclusion, by itself, should satisfy all foreign parties and any foreign policy concerns of the U.S. government.

North Dakota's interim committee studying the issue has already recommended adoption of water's edge legislation. Only Alaska remains, and corporate taxpayers have publicly expressed their satisfaction with the continued use of worldwide apportionment and combination in that state. Even California, the largest state with the longest experience in the practice of worldwide combination has recently enacted water's edge legislation.

This movement by the states accomplished in a little over two years what two decades of proposed federal restrictions could not. It clearly shows that states took the Working Group process seriously, and made a good faith effort to comply with all of the principles contained in the report. In most cases, business representatives and state officials engaged in long and detailed discussions to develop the laws appropriate to the individual states. Thus, the spirit of the Working Group continues at the state level.

But good faith state efforts have not been matched by an equivalent level of federal activity. Principle Two -- the increased federal assistance -- has been conspicuously lacking. The report of the Working Group sent to the President by Secretary Regan made this proposal:

> In order to demonstrate the good faith and sincere intentions of the federal government, I am proposing at this time that the Treasury Department move immediately to implement the federal assistance measures recommended by the Working Group... [Working Group Report, p. iii.]

In light of that proposal, made on July 31, 1984, what has been implemented to date? The Internal Revenue Service has invited limited numbers of state tax staffs to attend their training courses on international issues. There has been no discernible increase in IRS audit activity, no increases in international tax examination staffs, no provisions made for the sharing of information and assistance in audit activity, and no implementation of the joint state-federal study of Section 482 of the Internal Revenue Code. The most important item of all assistance -- the enactment of a requirement for a domestic disclosure spreadsheet -- has not been implemented but rather was first floated by Treasury as draft legislation more than a year after Secretary Regan's commitment to "immediate implementation," and when finally introduced was not an independent piece of legislation but rather was made part of the restrictive legislation before us today. This introduction directly contravenes the spirit of the Working Group effort. Thus the opposition of the Commission to this bill is based on several grounds. The first and most important of these is philosophical: by proposing to limit state taxation, this bill contradicts deeply rooted principles of federalism. "Federal intervention in state tax matters is objectionable in principle "wrote Governor Ronald Reagan in 1967, when Congress was considering restrictions on the use of worldwide combination. Any Congressional attempts to limit state autonomy need to be viewed warily. But taxation, since it is vital to state sovereignty, deserves especially close attention. Against an argument like this, only a finding of severe national harm should allow Congress to override traditional state prerogatives, and no one has ever successfully asserted that state use of worldwide combination is anything more than an irritant to some multinational corporations, and to some of their governments.

As a practical matter, the Commission endorsed in 1984 "as an equitable and acceptable alternative to worldwide combination" the use of comprehensive water's edge legislation provided it was adopted voluntarily by the states and not forced upon them. Its support for the Working Group approach was borne out in the subsequent two years when states began to recede from their use of worldwide combination. Even were the Commission not opposed to federal restrictions in principle, it would be opposed to this particular legislation since it so clearly violates the letter and spirit of the Working Group agreement, and upsets the balance of forces needed to bring the Working Group process to a successful conclusion.

The Commission also opposes this bill because it goes further than intruding into the fiscal affairs of a few states. By restricting state taxation of corporate dividends, it will overturn tax statutes in 27 states. These states would lose between $445 million and $550 million if the proposal became law. We wonder what national purpose is served by the Congress carving unwarranted and ill-conceived loopholes into long standing state tax policies.

In summary, the State of Montana and the member states of the Multistate Tax Commission oppose this bill because:

- It allows an unwarranted intrusion by the federal government into state tax policies.

- It violates the spirit and the letter of the Worldwide Unitary Taxation Working Group efforts to resolve disagreements between some states and multinational corporations.

- It goes beyond the usual concerns of unitary taxation to restrict the tax policies of 27 states regarding taxation of corporate dividends and certain domestic corporations.

Finally, we would urge the Congress to require the Treasury Department to immediately implement Secretary Regan's commitment of two years ago to provide federal assistance to the states in enforcing full disclosure by multinational firms. Without this critical element, the entire process of retreating from worldwide combination will simply result in shifting legitimate tax responsibilities of multinational firms to domestic corporations and small business.

September, 1986

UPDATED ESTIMATED ANNUAL REVENUE LOSSES RESULTING FROM S.1974 (WILSON BILL)

Total revenue loss for 27 affected states	$445-$550 million

State	Estimated Minimum Revenue Loss
Alabama	$102 thousand ***
Alaska	No current revenue loss *
Arizona	$1.3 million **
Arkansas	$750 thousand **
California	$350-$400 million ******
Colorado	No current revenue loss *
Connecticut	No current revenue loss *
Delaware	No current revenue loss *
District of Columbia	Foreign source prohibition would result in loss, but no statistics available *
Florida	No current revenue loss *
Georgia	No current revenue loss *
Hawaii	No current revenue loss *
Idaho	$20 million *****
Illinois	No current revenue loss *
Indiana	$8 million *
Iowa	$8.5-10 million *
Kansas	$15-20 million *
Kentucky	Would result in some loss, but no statistics available *
Louisiana	No current revenue loss *
Maine	Would result in some loss, but no statistics available *

Maryland	$2 million *
Massachusetts	No current revenue loss *
Michigan	No current revenue loss *
Minnesota	$1 million *
Mississippi	No current revenue loss *
Missouri	Foreign source prohibition would result in loss, but no statistics available **
Montana	$10 million *
Nebraska	Would result in some loss, but no statistics available *
Nevada	No corporate income tax
New Hampshire	$800-$900 thousand *
New Jersey	No reply
New Mexico	$2 million *
New York	Minimal current revenue loss *******
North Carolina	Foreign source prohibition would result in loss, but no statistics available ****
North Dakota	$7.5-9 million *
Ohio	No current revenue loss *
Oklahoma	$4.5-5.5 million **
Oregon	$4 million *
Pennsylvania	No current revenue loss
Rhode Island	$280 thousand ***
South Carolina	Would result in some revenue loss but no statistics available *
South Dakota	No corporate income tax

Tennessee	No current revenue loss **
Texas	No corporate income tax
Utah	$4.5 million *
Vermont	$150 thousand **
Virginia	No current revenue loss *
Washington	No corporate income tax
West Virginia	No current revenue loss *
Wisconsin	$5 million **
Wyoming	No corporate income tax

Sources:		
	*	Written or phone response to 1986 MTC survey.
	**	Letter from, or testimony of, state tax administrator.
	***	April 24, 1980, fact sheet prepared by Comm. on State Taxation (COST).
	****	May 11, 1982, state responses to Treasury questions.
	*****	The state's shift to "waters' edge" is not in effect until 1988.
	******	California's water's edge legislation does not go into effect until 1988. When the water's edge law does become effective, the revenue loss under S. 1974 would be $150-200 million.
	*******	MTC estimate based on recent changes in state law.

STATEMENT OF THOMAS H. BOGGS, JR., COUNSEL, UNITARY TAX CAMPAIGN, WASHINGTON, DC

Mr. BOGGS. Thank you, Mr. Chairman. My name is Thomas Boggs. I am a partner of the Washington law firm of Patton, Boggs & Blow. I appear today on behalf of the Unitary Tax Campaign, Ltd. The Unitary Tax Campaign is the United Kingdom organization that represents over 40 United Kingdom companies, most of whom have operations in the United States.

Mr. Chairman, I am accompanied by Mr. John Symons. Mr. Symons is the vice chairman of the organization. He is also the former vice president of BAT Industries. I have a lengthy statement, Mr. Chairman, which I would like to ask to be incorporated into the record.

Senator CHAFEE. Yes, we will put all the statements in the record.

Mr. BOGGS. I also have, Mr. Chairman, a comment filed by the Unitary Tax Campaign with the Treasury Department which presents our comments on the specific legislation which is before you. I would like that also put in the record.

Senator CHAFEE. Fine.

Mr. BOGGS. The Unitary Tax Campaign supports the enactment of Federal legislation which would generally apply the water's edge approach to State taxation of corporate income. Federal legislation is needed to ensure that the United States speaks with one voice on matters of international taxation and investment. The worldwide unitary controversy is fundamentally an international issue and, as such, can only be satisfactorily resolved at the Federal level.

Since the 1930's, nations have agreed on the separate accounting principle or the "arm's length principle," as the standard by which to measure and apportion business profits of enterprises which operate across national boundaries. The United States has been a leader in the establishment of the separate accounting principle as the standard for measuring income of such firms and avoiding double taxation of that income. Every bilateral income tax treaty to which the United States is a party adopts a separate accounting principle. The separate accounting principle also provides the backbone for the Internal Revenue Code's approach to the international income allocation. By strongly supporting the establishment of this separate accounting principle as a matter of both international and Federal law, the United States has clearly committed itself to this principle as a part of its international tax and investment policy.

State taxation on a worldwide unitary basis violates the internationally accepted standard of separate accounting. A haphazard array of individually adopted State water's edge laws will not provide an appropriate solution to the worldwide unitary controversy.

Federal legislation is still required for three primary reasons. First, Federal legislation would prohibit the imposition of fees or penalties on companies which avail themselves of a State-passed water's edge law. Second, Federal legislation would ensure a more stable U.S. commitment to a system of State taxation based upon the water's edge concept. Without Federal legislation, States that have acted to limit worldwide unitary taxation may reverse such legislative decisions at any time. And finally, Federal legislation would establish consistent guidelines for the enactment of a Federal network of State water's edge laws. Presently, the water's edge laws passed by States differ widely. These differences prevent the establishment of a consistent water's edge scheme across the country which would increase certainty for business transactions and reduce the business costs of complying with many widely varying State laws.

Mr. Chairman, in conclusion, what we are saying is that enactment of Federal legislation such as S. 1974 is needed to assure that States change their State taxation systems to be in compliance with Federal guidelines on international taxation lines. Now is a very appropriate time to have a Federal standard which these States can follow in achieving some consistency in this area. Thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much, Mr. Boggs. Mr. Glover.

[The prepared written statement of Mr. Boggs follows:]

September 22, 1986

STATEMENT OF THOMAS H. BOGGS, JR. BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, SEPTEMBER 29, 1986, ON S. 1974

ON BEHALF OF

UNITARY TAX CAMPAIGN, LIMITED

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This statement is submitted on behalf of Unitary Tax Campaign, Limited. Unitary Tax Campaign represents over 40 United Kingdom companies with international operations, including operations in the United States. These companies participate heavily in American trade and employ many American citizens.

I.

INTRODUCTION

Unitary Tax Campaign supports the enactment of S. 1974, which is before this Subcommittee for consideration, and its identical companion bill, H.R. 3980, which is before the House Committee on Ways and Means.

The legislation was drafted by the Administration and was introduced into both Chambers at the request of the President. S. 1974 was introduced on December 10, 1985, by Senator Pete Wilson (for himself and Senators Mathias and Hawkins). H.R. 3980 was introduced on the same date by Congressman Duncan. Since introduction, Congressmen Gibbons, Jenkins, Archer, Frenzel, and Daub have agreed to co-sponsor H.R. 3980.

In brief, the legislation would apply a "water's edge" approach to State taxation of corporate income by: (1) prohibiting States from imposing corporate income tax on a worldwide unitary basis; and (2) providing for equitable tax treatment of dividends received by U.S. corporations from their foreign subsidiaries. In exchange, all States would benefit under the legislation from the establishment of new Federal information reporting requirements for multinational corporate groups and certain other corporations. These information provisions are intended to assist States in the administration of their tax laws.

This legislation is the most recent attempt to correct a problem which has plagued national governments and the business community for many years. As has been documented many times over the long history of the worldwide unitary debate, State taxation on a worldwide unitary basis: (1) allows a State to tax income which is earned outside the United States and is not related in any way to a taxed company's operations in the State; (2) requires a determination of income which is based on apportionment factors that can significantly understate income earned by foreign operations and overstate income earned in the State and therefore results in double taxation; and (3) results in oppressive administrative and compliance costs for companies which are required to report on their complete worldwide operations, even though such information is often not readily available to an international trading company. For these reasons, taxation on a worldwide unitary basis is wrong as a matter of tax policy.

Perhaps even more importantly, however, State taxation on a worldwide unitary basis is inconsistent with the positions taken by the United States on international tax and investment matters. The contours of international tax and investment policy are determined through careful and laborious negotiations among the national governments. State taxation on a worldwide unitary basis is inconsistent with most of the international agreements reached through these negotiations. Foreign governments, many the principal trading partners of the United States, view State worldwide unitary tax systems as distinctly at variance with the Federal tax system, and these governments are therefore troubled by the inability of the United States to make consistent commitments on international taxation matters. For this reason, State taxation on a worldwide unitary basis has a significant negative effect on United States relations with the governments of its major trading partners.

Recently, the State of California enacted a water's edge approach to corporate taxation. California's action leaves three States (Alaska, Montana and North Dakota) which impose tax on a worldwide unitary basis. While the number of such States has been reduced to three, Federal legislation such as S. 1974 is still required for three primary reasons.

First, Federal legislation such as S. 1974 would prohibit the imposition of fees or penalties on companies which avail themselves of a State-passed water's edge bill. For example, the new California law imposes an "election fee" equal to .03 percent of the sum of a taxpayer's property, payroll and sales in California. In effect, such a fee requires a taxpayer to pay for the privilege of not being taxed under a system which: (1) is wrong as a matter of tax policy; (2) undermines United States positions on matters of international taxation; and (3) is disapproved by the Administration. The right to be freed from taxation on a worldwide unitary basis should not be treated as a privilege. As a matter of principle, such "election" fees should not be permitted, and Unitary Tax Campaign will continue to lobby the California legislature to seek the eradication of the "election" fee. S. 1974 would not permit such fees.

Second, Federal legislation would ensure a more stable U.S. commitment to a system of State taxation based on the water's edge concept. Without Federal legislation, States which act to limit worldwide unitary taxation may reverse such legislative decisions at anytime. This unstable situation could very likely be exacerbated by the presence of legislative clauses which permit State tax administrative agencies the discretion to impose worldwide unitary taxation for a wide range of violations of State legal requirements. The new law passed by California includes such a discretionary provision.

Third, Federal legislation would establish consistent guidelines for the enactment of a federal network of state water's edge laws. Presently, the water's edge laws passed by States differ widely. For example, State water's edge laws provide varying definitions of which corporations are within or without the "water's edge." Such differences prevent the establishment of a consistent water's edge scheme across the country which would increase certainty for business transactions and reduce the costs of complying with many widely varying State laws.

Federal legislation such as S. 1974 would establish stable and consistent guidelines for State taxation of corporations which have international operations. By establishing this consistent baseline, S. 1974 would provide a solution to the continuing foreign policy problem of the United States caused by State taxation on a worldwide unitary basis.

II.

TAXATION ON A WORLDWIDE UNITARY BASIS IS INCONSISTENT WITH THE POLICIES OF THE UNITED STATES

State taxation on a worldwide unitary basis is inconsistent with the long-established position of the United States and other nations on matters of international taxation. Because it is inconsistent, this State taxation practice undermines the ability of the United States to speak with one voice on matters of international tax and economic policy. The solution to this Federal problem should be the enactment of Federal legislation. The "water's edge" approach of S. 1974 would provide an appropriate solution to this Federal concern in a responsible and even-handed manner.

A. The United States Has Committed Itself to the Separate Accounting Principle as a Matter of International and Federal Law.

When a business enterprise earns income in different jurisdictions, some means must be employed to measure the income earned in each of the various jurisdictions. If no such means is in place, then it is possible that the total income of the enterprise may be taxed several times by the various tax jurisdictions in which its constituents operate.

Since the 1930's and the beginning of a substantial international commerce, nations have agreed on the "separate accounting" principle (sometimes called the "arms length" principle) as the standard by which to measure the business profits earned in each jurisdiction where the constituent parts of an enterprise operate. Under this "separate accounting" principle, income earned in each jurisdiction is measured according to established accounting principles. Each corporation in a multi-corporate group is treated as a separate entity which will deal with all other entities on an "arm's length" basis. As a safeguard against tax avoidance, tax authorities are empowered to enforce the separate accounting principle by adjusting taxable income where necessary to make it conform fully with the "arm's length" assumption.

The United States has been a leader in the establishment of the separate accounting principle as the international standard. Every bilateral income tax treaty to which the United States is a party adopts the separate accounting principle as the method for measuring multi-jurisdictional income and avoiding double taxation of that income. The separate accounting principle is adopted by the model income tax treaties of both the Organization for Economic Cooperation and Developement (OECD), whose members include the United States and its principal trading partners, and the United States Treasury Department. These model treaties provide the basis for negotiations to establish bilateral income tax treaties. Most tax treaties between other nations also adopt the separate accounting principle. To prevent tax avoidance through artificial transfer pricing, most national governments have generally agreed to exchange tax information under bilateral tax treaties or separate executive agreements. By strongly supporting the establishment of the separate accounting principle as the international standard, the United States has taken a clear position in favor of the separate accounting principle as a matter of international law.

The separate accounting principle also provides the backbone for the Internal Revenue Code's approach to international income allocation. The Code implements the separate accounting principle in three steps. First, the Code establishes detailed and sophisticated rules to determine the source of each item of a firm's income. These "sourcing" rules serve to allocate income to the tax jurisdictions where income is earned. Second, the foreign tax credit ensures generally that any tax charged by a foreign government on foreign-source income which is also taxed by the United States will be credited against any United States tax liability on that income. The effect of the foreign tax credit is to avoid double taxation of income earned by transnational enterprises. Finally, to prevent tax avoidance through artificial transfer pricing, the Treasury Department has promulgated regulations under section 482 of the Code which explicitly adopt the "arm's length" pricing standard. With these three steps, the United States has clearly committed itself as a matter of Federal law to the separate accounting principle as the standard for measurement and taxation of income of multi-national enterprises.

B. State Taxation on a Worldwide Unitary Basis Violates the Internationally-Accepted Separate Accounting Principle.

State taxation on a worldwide unitary basis violates the internationally-accepted norm of separate accounting and therefore undermines the commitments made by the United States in matters of international taxation. While many States use some form of the unitary method to divide domestic income (income earned in the United States) among the various States, only a small minority of States apply the unitary method on a worldwide basis. It is this practice -- taxation on a worldwide unitary basis -- which is inconsistent with United States policy.

Unlike the separate accounting principle, the unitary principle ignores both the existence of separate corporate entities and the source of income and instead attempts to apportion income among tax jurisdictions through application of a mathematical formula. Under the unitary principle, income of a "unitary business" is aggregated into a single income base. The "unitary business" may consist of dozens of separate corporations that are related in terms of ownership and business activity. Part of the aggregate unitary income base is then apportioned to a tax jurisdiction by multiplying the unitary income base by a fraction. Typically, this fraction is equal to the ratio of an enterprise's sales, payroll and property located in the jurisdiction to its total sales, payroll and property.

States which tax on a worldwide unitary basis extend the unitary principle beyond U.S. borders to include income earned by foreign corporations from operations in foreign countries. By doing so, these States impose tax on foreign source income of foreign affiliates without having negotiated any regime for avoiding double taxation with foreign governments. Because the foreign governments are not parties to the apportionment system used by the small minority of worldwide unitary States and will have already taxed such income under their own laws, a second tax is effectively imposed when such foreign source income is taxed by a State.

This system is grossly distortive because it makes no allowance for the tax levied (legitimately) by the source country and, even more fundamentally, operates on the entirely artificial assumption that each dollar of sales, payroll and property invested in a worldwide unitary State produces precisely the same income as each dollar of sales, payroll and property invested worldwide.

C. State Taxation on a Worldwide Unitary Basis Undermines the Relationships of the United States with Other Nations.

The disharmony which results when a State's worldwide unitary taxation system is interposed with the international tax system has alienated most of the principal trading partners of the United States. This alienation has existed for at least ten years.

For example, in 1976, the United States Treasury Department negotiated a bilateral income tax treaty with the United Kingdom which included Article 9(4). Under this Article, the United States and the United Kingdom agreed not to impose corporate income tax on a worldwide unitary basis. This provision orginally would have applied the limitation to not only the Federal government, but to State governments as well.

During consideration of the Treaty by the Senate Foreign Relations Committee, Senator Frank Church attempted to remove the limitation of Article 9(4) by reservation. That Amendment was defeated by a vote of ten to five. When the full Senate debated the Treaty in June, 1978, Senator Church again proposed the reservation regarding 9(4), and the reservation was again defeated by forty-four votes to thirty-four. In the final vote by the Senate on the Treaty the following day, forty-nine voted in favor, and thirty-two against, five votes short of the required two-thirds majority. After several days of discussions, the Treaty was ratified by a vote of eighty-two to five, with the Church reservation included, the Treasury Department having capitulated to gain passage of the Treaty with no further hindrance. Since then, there has been no action in Congress to rectify the situation.

More recently, foreign governments have expressed their opposition to State taxation on a worldwide unitary basis in letters from their Embassies to Chairman Packwood and Chairman Rostenkowski. These letters, dated April 29, 1986, were signed by representatives of sixteen countries and the Commission of the European Communities.*/ In part, these letters expressed the official understanding of these Governments of the Administration's position on the worldwide unitary issue:

> The sixteen countries and the Commission of the European Communities which are

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*/ These sixteen countries are Austria, Belgium, Canada, Denmark, Federal Republic of Germany, France, Greece, Iceland, Italy, Japan, Luxembourg, Netherlands, Portugal, Spain, Switzerland, and the United Kingdom.

> signatories to this letter view the use of worldwide unitary income taxation by certain States as a serious divergence from the long-established principles of international corporate taxation. The Administration has recently affirmed that it takes a similar view, as evidenced by the President's statement of November 8, 1985, and the introduction of S. 1974. Secretary Baker's March 5, 1986 letter to you [Chairman Packwood or Rostenkowski], Secretary Shultz's letter to State Governors and the Justice Department's amicus curiae brief in the Alcan Aluminum/ICI action against California in the Federal District Court in Illinois provide further confirmation. The Administration has stressed in particular the damage that worldwide unitary income taxation has done to relations with some of its major trading partners. Thus, we are hopeful that your Committee . . . will consider expeditiously this legislation.

As referenced in these letters, the Administration has recognized the serious and continuing foreign policy concerns caused by State taxation on a worldwide unitary basis. The Secretary of State recently made clear these concerns in letters to the Governors of States which imposed tax on a worldwide unitary basis. In part, the Secretary of State said:

> Continued State taxation on a worldwide unitary basis will greatly impair the ability of the Federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic notes complaining about State use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral treaty negotiations.

Through such public expressions against State taxation on a worldwide unitary basis, the Administration has committed itself to an effort to ensure that this practice no longer undermines United States foreign policy. As part of this effort, the Administration drafted S. 1974. With three States still imposing tax on a worldwide unitary basis and other States, such as California, enacting water's edge laws which contain objectionable clauses, Federal legislation such as S. 1974 is still needed to assure that the United States satisfactorily resolves the worldwide unitary issue.

III.

CONCLUSION

State taxation on a worldwide unitary basis has produced a significant deterioration in the relationships of the United States with its principal trading partners. This method of State taxation has undermined the ability of the Federal government to speak with one voice in foreign policy matters. Continued use of this method by individual States will impair the ability of the United States to carry out its tax and investment policy in the international arena, further alienate our economic allies and expose the United States business community to increased taxation and administrative costs in foreign jurisdictions. A haphazard array of individually-adopted State water's edge solutions, with various "election" fees and other inappropriate provisions, will not provide a solution to the worldwide unitary controversy.

S. 1974 is Federal legislation which will resolve these foreign policy problems. The water's edge approach of S. 1974 will permit the Federal government to regain control of United States international tax policy. This bill would provide simple and fair guidelines for States to enact a consistent network of water's edge legislation. In recognition of this fact, the executive branch of our government -- the President, the Treasury Department and the State Department -- all support the enactment of S. 1974.

Unitary Tax Campaign, along with others who support S. 1974, has submitted a series of suggested changes to S. 1974 to the Treasury Department. The most important of these issues are discussed in Attachment A of this Statement.

Representatives of Unitary Tax Campaign would welcome the opportunity to work with the Subcommittee and its staff to resolve these technical issues and otherwise to assist in the consideration of this legislation.

ATTACHMENT A

SUGGESTED CHANGES TO S. 1974

While Unitary Tax Campaign supports Federal legislation to prohibit State taxation on a worldwide unitary basis, S. 1974 contains several provisions which should be modified.

A. Imposition of Worldwide Unitary Taxation Should Not Be a Penalty for Noncompliance

The provisions of S. 1974 establish two conditions to the general prohibition against State taxation on a worldwide unitary basis. Specifically, a State would still be able to tax on a worldwide unitary basis if: (1) a taxpayer "materially fails" to comply with the new Federal information reporting requirement or with "the legal or procedural requirements" of State income tax laws; or (2) neither the taxpayer nor the government of the "relevant foreign country" provides "material" information to a State after "proper request."

The establishment of any conditions is improper. The prohibition of taxation on a worldwide unitary basis should not be treated as a privilege. This practice violates basic principles of taxation and is contrary to the policies of the United States. To sanction use of this practice for any reason, including as a penalty for noncompliance with information requirements, is improper. Rather, the legislation should penalize noncompliance by the imposition of separate penalties. Such penalties are open and direct sanctions for noncompliance and are the usual manner in which the United States enforces the information return requirements of its own tax laws.

In this connection, it should be noted that Unitary Tax Campaign does not oppose the inclusion in the legislation of reporting requirements based upon the concepts of the domestic disclosure spreadsheet contained in Principle III of the Worldwide Unitary Taxation Working Group. However, these information requirements should function independently of the prohibition against State taxation on a worldwide unitary basis. In addition, the reporting requirements should be drafted with a greater degree of precision to enable firms to comply with the requirements in good faith and without uncertainty. Similarly, S. 1974 should be amended to specify the procedure under which a "proper request" for information may be made to a foreign government. In general, Unitary Tax Campaign believes that States should obtain information only from the United States government to the extent permitted by any tax treaty or executive agreement to which the United States is a party.

B. The Threshhold Should Be Changed

The proposed legislation contains provisions to define foreign corporations which are within the "water's edge" and thus subject to unitary taxation. In general, the proposed legislation would establish a two-pronged test to determine whether a foreign corporation is within the water's edge. Specifically, a foreign corporation must either: (1) have at least $10 million in compensation payments, sales or purchases, or property assignable to United States locations; or (2) have at least 20 percent (an average of percentages) of its total compensation payments, sales and property assignable to United States locations.

Unitary Tax Campaign has consistently taken the position that the proposed legislation should adhere to the principles the United States espouses in the double taxation agreements into which it has entered. Thus, the water's edge definition should be based upon the concept of a "permanent establishment." If, however, the "permanent establishment" concept is not adopted, the test to determine whether foreign corporations are within the water's edge should be a simple calculation based on an analysis of the sources of the corporation's gross income. For example, if at least 20 percent of a corporation's worldwide gross income consists of U.S.-source income which is not effectively connected with a U.S. trade or business or income from U.S. or foreign sources which is effectively connected with a U.S. trade or business, then the corporation would be within the water's edge and subject to taxation on a worldwide unitary basis.

C. The Branch Provision Should Be Expanded

The proposed legislation provides that a United States bank branch of a foreign corporation may be treated as a separate United States corporation. This provision recognizes that banks generally may not incorporate subsidiaries and prevents the treatment of all of the foreign corporation's income as within the water's edge merely because the bank branch is located in the United States.

The provision, however, should not be limited only to branches of foreign-based banks. Other situations exist where a multinational enterprise may be required to operate through a single multinational company with a large number of branches. Such a case should qualify for treatment similar to that provided for foreign-based banks in the proposed legislation.

STATEMENT OF JERE W. GLOVER, GENERAL COUNSEL, NATIONAL SMALL BUSINESS ASSOCIATION, WASHINGTON, DC

Mr. GLOVER. Thank you. My name is Jere Glover, and I am here today as counsel for the National Small Business Association. Prior to entering private practice, I served as deputy chief counsel for SBA, and prior to that on the House Small Business Committee.

One might ask, "why does small business care about how multinationals are taxed?" We start off with the basic premise that all small businessmen believe in; taxation is evil, it is un-American, it causes cancer, and it simply should not exist. Having said that, we have to proceed with some basic realities. Taxes do exist. Someone must pay them. Small businesses don't want to pay them; we would prefer big businesses and especially multinationals to do that.

When you think about it, multinationals are here today saying the very same thing: We don't want to pay taxes; let somebody else. Well, small business is that somebody else. We have three specific instances where State legislatures have looked at the issue of whether they should abolish unitary taxes and whether they should give preferential treatment to multinational corporations. You can see the situation in Florida where a 20-percent increase in the corporate rate was applied after unitary was repealed. We look at Illinois; we see that Illinois went from 4 percent corporate tax rate to 4.8 percent.

We look at Massachusetts where the Governor proposed increasing all payroll taxes in the State by 1 percent so that they could repeal unitary. So, let's not kid ourselves about what ends up happening when unitary taxes are abolished. When the States need revenue and they look around and decide to exempt multinational corporations or to prohibit unitary basis.

Quite simply, that burden is shifted to the other businesses within the State, and we as small business people don't have a lot of choices. We end up paying on a unitary basis, because we don't have any way of shifting revenues or profits outside of a specific State, or can we shift them outside the United States.

So, our concerns are very simple. We believe that the States should have the option to propose the same type of tax accounting method for multinational corporations that they do for their local corporations. We believe that we have had all too many instances where fairness has not been afforded the small businesses.

I would like to thank Senator Baucus and Senator Grassley for their work in correcting some of that in the past bill. I know they fought very hard on the self-employed insurance deductibility issue and were successful in getting that included. But by and large, small businesses don't have the wherewithal or the money for the lobbyists to come up here and argue effectively and certainly don't have the PAC money. But we do have one basic thing which we believe in very strongly, and that is basic fairness.

We believe that all corporations, be they multinational or domestic, should be treated the same way. Fairness is the only real hope that we have for equitable treatment, and we would urge that you not pass this legislation. Thank you.

Senator CHAFEE. Thank you very much, Mr. Glover.

[The prepared written statement of Mr. Glover follows:]

National Small Business Association

"The Voice of Small Business"

Founded 1937

STATEMENT OF

JERE GLOVER

ON BEHALF OF

THE NATIONAL SMALL BUSINESS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT

SENATE COMMITTEE ON FINANCE

HOLDING HEARINGS ON

S. 1974, THE UNITARY TAX REPEALER ACT

SEPTEMBER 29, 1986

> "It is the declared policy of the Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small business concerns in order to preserve free competitive enterprise..."
>
> P.L. 85-536, as amended, Section 2(a), Small Business Act.

1155 15th Street, N.W. 7th Floor • Washington, D.C. 20005 • Telephone (202) 293-8830

STATEMENT OF JERE W. GLOVER ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION BEFORE THE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT SENATE COMMITTEE ON FINANCE HOLDING HEARINGS ON S. 1974, THE UNITARY TAX REPEALER ACT

SEPTEMBER 29, 1986

Mr. Chairman and Members of the Subcommittee:

My name is Jere W. Glover, and I am here today on behalf of the National Small Business Association (NSB). I am the General Counsel of NSB and serve on its Executive Committee. I appreciate the opportunity to appear before you today on the issue of unitary taxation and its impact on the small businesses of America.

The National Small Business Association is a bipartisan trade association which, since 1937, has represented small businesses located in every state in the Union. Testifying before Congress on legislation of interest to small business is a function we regard as vitally important to the interests of the more than fifteen million American small business enterprises.

We are here today to address specifically S. 1974, introduced by Senator Wilson, and S. 1113, introduced by Senator Mathias. Both bills would severely restrict state taxation of multinational corporations. The National Small Business Association opposes any proposal to give special tax breaks to multinational corporations. Multinationals that operate through subsidiaries should not be exempt from the unitary method of accounting that most states use as a basis for computing the tax owed by corporations. Without equal application of the unitary method to all corporations, small in-state businesses will be put at an unfair competitive disadvantage simply because they lack the same opportunity as multinational corporations to shift profits among foreign subsidiaries and thus avoid taxation.

The unitary method of tax accounting was upheld by the United States Supreme Court in the 1983 case of Container Corporation of America v. Franchise Tax Board as a "proper and fair method of taxation." The unitary accounting method treats the corporation as a single taxpayer, regardless of whether it conducts its business through one corporation or through a variety of subsidiaries and affiliates. A state, unlike the federal government, is limited to only taxing the corporation on the amount of business income generated within that state. To determine how much of a corporation's business profits are generated within the state under the unitary method, a formula is used comparing the ratio of business activity in each jurisdiction to the company's total business activity everywhere. In other words, it takes into account total corporate earnings and assets regardless of where they are realized. The corporate tax owed the state is then computed on the profit share attributable to that state.

The alternative separate accounting, also referred to as the "arm's length" method, has been shown by the General Accounting Office and others to be ineffective, difficult to audit, and not subject to even enforcement, thus allowing in-state profits to escape taxation by the state.

Most states have always applied the unitary method of tax accounting to those businesses engaged in inter/intrastate commerce. However, only those corporations large enough to have subsidiaries can transfer their tax liabilities outside a particular state.

When multinational corporations, using sophisticated accounting manipulations, transfer their tax liability outside the particular state, the remaining domestic firms -- the small businesses that create most new jobs -- are left to shoulder the bulk of the state's tax burden. Tax avoidance by multinationals imposes a heavy cost on small business. Every dollar of legitimate taxation bypassed by multinationals must be paid for by other taxpayers, both corporate and individual. For example, after Florida repealed its use of the worldwide unitary tax accounting method, the legislature raised the corporate tax rate from 5% to 5.5% to remedy the shortfall in revenues. Small businesses in Florida now must pay higher state taxes so multinationals operating there can pay lower ones. Similarly, one year after Illinois caved in to pressure from big oil companies and retreated from worldwide unitary to domestic unitary, the state corporate tax rate was increased from 4% to 4.8%.

Even at the Federal level large corporations only pay an effective tax rate of approximately 17%. The average small and mid-size business tax rate is double that paid by large corporations.

Shortly after the Container Corporation case was decided by the Supreme Court, then-Treasury Secretary Donald Regan announced the formation of a Worldwide Unitary Working Group to study worldwide unitary apportionment. The report issued by that group further demonstrates why the "water's edge" combination definition embodied in S. 1974 is a loophole-ridden definition.

There are two large avenues provided in S. 1974 through which multinationals may avoid state taxation of their legitimate taxable in-state earnings. First, by permitting "water's edge" corporations to exclude "80/20" corporations (firms headquartered in the United States with 80% of their property and payroll overseas -- even though all of its sales are in the United States) allows these firms to avoid taxes by skillful accounting machinations. More importantly, it destroys American jobs by creating a tax incentive for firms to pack up their American plants and move them overseas.

The second avenue through which state taxes may be avoided under this bill is the near total exemption of foreign dividends from inclusion in the tax base. Such an exemption would force down investment and job creation in the United States by giving preferential treatment to operations outside the borders of the country. This clearly discriminates against small businesses which would continue to pay both state and federal corporate income taxes on the full base of their profits.

If legislation is passed prohibiting the unitary tax method of accounting, this will not affect the method by which small businessmen and women pay their corporate taxes. Small business people are not able to shuffle their profits across the state border to give the slip to the state tax man. There is no reason why multistate corporations should be allowed to do so. This type of legislation clearly benefits only one group, multinational corporations.

Study after study has documented that small business is responsible for creating the majority of new jobs in our economy.

Yet, once again, consideration is being given to putting small business at a competitive disadvantage. At a time when the federal deficit is reaching record levels and America's balance of trade is spiralling out of control (approximately $140 billion), the last policy which should be pursued is one that encourages the multinationals to move their operations overseas while inhibiting our own small business sector. Small businesses are the most productive segment of the economy, leading the nation in job creation and innovation, providing the driving force behind the present economic recovery. According to President Reagan's Report, The State of Small Business, between 1980 and 1982 small businesses created all, every single one, of the 984,000 net new jobs in the United States. All businesses created 2.65 million new jobs, but that was offset by the fact that big business posted a net loss of over 1.6 million jobs. The Fortune 1,000 have fewer employees today than in 1969. In addition to job creation, small business leads the way in innovation. Over two-thirds of all innovations have come from small business. This is ample proof that President Reagan's economic recovery was largely a product of America's small businesses.

Some proponents of federal restrictions on state taxation of multinationals claim that lowering their tax will promote investment and job creation. Numerous studies indicate that state and local taxes are not the primary issue in capital investment or business location decisions. Moreover, there is no evidence that worldwide unitary tax accounting methods inhibit foreign investment. Even if we assume some multinationals will cut back the activity in states that apply the unitary method even-handedly, there are more than enough entrepreneurs and smaller firms ready to fill the gap. Where there is a market, a resource, or a skilled labor force, small business will make the investment and create the jobs. The support multinational corporations display for S. 1974 demonstrates that they will only invest and create jobs when encouraged by a specific special tax subsidy. Indeed, by artificially subsidizing uneconomic spending by multinationals, restriction on the unitary method will diminish aggregate investment in the United States.

Nor will the lower rate of corporate taxation assist America in reducing its trade deficit. The staff of the Congressional Joint Committee on Taxation summarized the results of a study of corporate tax burdens in large developed countries around the world. It concluded:

"In 1982, the country with the second largest trade surplus, Japan, had the highest rate of corporate taxation measured both as a portion of gross domestic product (5.4 percent) and of total tax revenues (19.7 percent). Conversely the country with the largest trade deficit, France, relied the least on corporate taxes as a revenue source."

The unpopularity of the unitary method with multinational corporations is not without reason. These corporations are not accustomed to being made to pay their fair share of taxes at the state or federal level. The unitary method forces out-of-state corporations to pay their fair share of the benefits they receive by virtue of operating in that state.

The National Small Business Association is firmly opposed to any legislation that results in unfair methods of tax accounting that assists multinational corporations at the expense of the American small business.

We believe that all businesses, large and small, should be subject to the same fair share of state taxes.

Thank you for the opportunity of appearing before you today on this subject of importance to the small business community.

# # #

Senator **Chafee**. What percentage of your members are incorporated?

Mr. **Glover**. Approximately three-fourths of National Small Business Association members are incorporated.

Senator **Chafee**. All right. Now, Mr. LaFaver, could you respond to the statement Mr. Hurston made regarding Montana not taxing foreign multinationals but taxing U.S. multinationals?

Mr. **LaFaver**. We have both on operational and a constitutional reality here. The Supreme Court in the container case certainly hinted rather strongly that application of worldwide combination to a foreign parent was probably not constitutional. So, that is one part. The second part, from an operational standpoint, is that a small State such as Montana simply doesn't have the audit power—the manpower—to send teams of auditors to the Netherlands to audit that sort of a firm. So, we stick solely as a matter of administration to domestic parents and we will propose legislation in 1987 to make it a matter of law that Montana does not include the foreign parent in the worldwide combination.

Senator **Chafee**. That does seem a little rough, doesn't it? I mean, tax the U.S. people, of the U.S. multinationals, but not the foreign multinationals?

Mr. **LaFaver**. I guess I don't understand why that is rough. We tax our own citizens, but don't have the authority to go down to a foreign nation and tax them.

Senator **Chafee**. No, but I don't think the analogy is totally apt. You are saying that Coca-Cola has worldwide sales and your Montana collects from the Coca-Cola Co. based on some apportionment figure; but when the Shell Oil Co. comes along, they are treated differently. You don't compute in—I guess that is what you are saying if I understand it—you don't compute in what Shell's worldwide sales are because you can't get those. So, you just base it on some local sales; is that correct?

Mr. **LaFaver**. We allocate income to Montana from a domestic parent based on their worldwide factors, and under the Constitution of the United States, according to container, we have the authority to. We don't have the authority to very likely with a foreign parent.

Senator **Chafee**. Do you want to comment on that, Mr. Hurston?

Mr. **Hurston**. No. The only valid argument I heard him make for discriminating against U.S. companies was audit capability, and I thought he was representing the Multistate Tax Commission which was formed for that purpose, to provide audit support for the States.

Senator **Baucus**. Mr. Chairman, if I might make a point while we are on this subject?

Senator **Chafee**. Surely.

Senator **Baucus**. The question here really and the reason for the legislation is because of the perceived unfair application to foreign companies—foreign companies in foreign countries. That is the reason for the United Kingdom retaliation. If the State of Montana and if other States apply water's edge or something similar to water's edge to foreign-based companies, that is do not apply the worldwide unitary to foreign-based, but if they still do to U.S. based multinationals, the fact that they do not against foreign based obviates the need for this legislation, obviates the need for any retaliatory United Kingdom legislation. There is an entire different, separate question, and that is should the States as a matter of policy or as a matter of tax policy treat U.S. based any differently than they treat foreign based?

Should there be any "discrimination"? That is a separate matter for the State of Montana to determine as a matter of State policy, but because Montana does apply a water's edge—or practically as I understand it a water's edge—to foreign based, then there is no need for this legislation insofar as this legislation is based on potential United Kingdom and foreign country retaliation.

Senator CHAFEE. That is one approach to this.

Senator BAUCUS. One can argue whether it is proper for the State as a matter of State tax policy to treat U.S. based differently; that is a whole separate question. Frankly, my personal view is that the State of Montana should revise its tax policy. The fact is that in the State of Montana, this is a major issue. When the legislature meets this next January, there will be several bills addressing the unitary question.

It is certainly in view of California's action and this potential legislation today that there are many legislators in the State of Montana pressing for repeal. And if I were a State legislator, I would, too; but the fact is that it is up to the State legislature.

Senator CHAFEE. Just out of curiosity—and I presume your State is somewhat typical of the other States—perhaps not Alaska, but possibly of North Dakota—what percentage of your State revenue is derived from this tax? Do you know?

Mr. LAFAVER. Yes. One-fifth of the corporation license tax comes as a result of applying worldwide combination.

Senator CHAFEE. That is one-fifth of the corporation license tax, but I really would like to direct my question to: What percentage of the total revenue? In other words, there are probably other forms of taxation of corporations, plus a whole series of excise taxes. In other words, if we repeal this—just take an "if"—if we repeal this tax, what would it cause you to lose percentagewise of your revenue, your total revenue, of your State?

Mr. LAFAVER. We would likely lose between 4 and 5 percent.

Senator CHAFEE. Of your total revenue?

Mr. LAFAVER. Of all revenue, yes.

Senator CHAFEE. Mr. Boggs, what do you say to the argument that has been presented here that all they want to do is just tax U.S. corporations and we won't bother with the foreign multinationals? So, what harm does that do with Britain?

Mr. BOGGS. Mr. Chairman, from a foreign corporation's point of view, a State which has adopted an appropriate water's edge concept does not apply its taxing jurisdiction beyond the water's edge to foreign corporations. Obviously, in the case of such a State, foreign corporations would have no real complaint about the State taxation system.

I think what the British companies would say is that they don't necessarily trust a temporary hiatus in the unitary tax method. It was here before; it could come back again. I think what they would like to see is uniformity and certainty, either by way of the United States-United Kingdom treaty, which is certainly one course of action, or by way of Federal legislation.

Senator CHAFEE. Mr. Glover, I heard your testimony and read it. I am not sure there is exactly cause and effect. You pointed out that in Illinois and in Florida, they repealed this tax, and the following year they increased the corporate tax by a half a percent, I guess, in each case. In your judgment, was that cause and effect?

Mr. GLOVER. If one reviews the hearings in both of the legislatures involved and the messages from the Governors, you will find that those numbers were used to take care of the revenue loss that resulted from repealing unitary basis for taxation in those specific States, and it was so stated at the time the legislatures did it. So, I believe there is a fairly clear indication that there was a cause and effect relationship that was fairly clear.

Senator CHAFEE. You indicated that three quarters of your members are incorporated?

Mr. GLOVER. Yes, sir.

Senator CHAFEE. Do you have any further breakdown of those incorporated? What percentage are subchapter S?

Mr. GLOVER. No, sir, I do not.

Senator CHAFEE. It seems to me that would be very significant. I would suspect that a very substantial portion of them are. Do you have any tilt on that?

Mr. GLOVER. Obviously, there are a number of them. I would say that between 50 and 60 percent of our membership would not be subchapter S; they would be corporations but not subchapter S. With the new tax law, that may well be changing. We may well see a lot more small businesses becoming subchapter S corporations, but certainly in our membership now that is not the case.

Senator CHAFEE. Mr. Hurston, you have heard this testimony. What does this do if Mr. LaFaver's views persist not to tax the multinationals that are doing business, but just tax the domestic ones? What does this do to your competitive position internationally?

Mr. HURSTON. Certainly, Senator, if a Japanese company were making money in Mexico and Coca-Cola Co. has the same or similar operation in Mexico, we would be subjected to a much higher tax burden in the State of Montana based on those activities in Mexico. It is as clear and simple as that. They are taxing the income and the activities of the Coca-Cola Co. overseas where the parallel operation of a foreign based multinational would not be taxed and included in the tax base in those States. A clear case of discrimination and the best argument I have seen from his own explanation of why Federal legislation is needed.

It is also incomprehensible that the same people that oppose it—that is Federal legislation in the area of worldwide combination—are supporting legislation that would overturn Supreme Court decisions. Again, Senator, Supreme Court decisions in the areas of sales use taxes in the *National Bellas Hess* case. The National Association of Tax Administrators and the Multistate Tax Commission are both supporting legislation that would in fact overturn the Supreme Court decision and give the States' the prerogative to tax in the sales use tax area, a very inconsistent position I would say.

Senator CHAFEE. I must say I am somewhat appalled by the view that one should tax our people but don't tax on the same basis—tax our overseas earnings, but don't tax the foreigners overseas. I am not for the thing at all, but to go on that basis is the worst of all solutions, as I view it. I may be missing something here.

Senator BAUCUS. Mr. Chairman, I agree; but shouldn't a State have the right to make that decision? Coca-Cola can, if it wants to, opt not to do business in Montana——

Mr. HURSTON. That would be the criteria, Senator?

Senator BAUCUS. What I am saying is that obviously that would be very disadvantageous to the State of Montana as well as to the Coca-Cola Co.; and that is why I think the State of Montana should decide to change. I agree with you, Mr. Hurston, but I still think that that is a matter of State policy.

Senator CHAFEE. Coca-Cola fortunately is of such a nature that it is hard for me to name a Japanese competitor of Coca-Cola; but let's take the automobiles. Let's take Ford and Toyota. Under Mr. LaFaver's approach, Ford, who clearly does business in Montana, you take their overseas total and Ford has extensive operations in Europe and England especially and all over the world. So, you take the total Ford earnings and, based on that, and their operations in Montana, you then would work out a system whereby you would tax Ford and they would come up with quite a big bill. But you take Toyota and you would say, no, we are disregarding what you are earning overseas because we can't seem to get the information. And so, we are just taking it based on the business you do in Montana; so, Ford gets penalized. That is hardly the thing I am enthusiastic about.

Mr. LAFAVER. May I respond, Mr. Chairman?

Senator CHAFEE. Sure.

Mr. LAFAVER. I don't think that that is an accurate way of explaining it. We don't tax either the Japanese firm or the American firm more than their presence in Montana would allow. Ford might have operations in every nation of the world but they are taxed only on their factors in Montana. The larger they are worldwide, the larger they are in South America, and so forth, the smaller their factors are in our State.

When you look at the Japanese firm, you only look at the subsidiary that is operating in the United States; but you allocate its income to Montana in exactly the same way, using the same unitary calculation, that you do with Ford. So, the issue that occurs to us is that: Do you allow foreign firms to allocate income away from your State and to States that don't have a corporation income tax, or do you apply the tax on an objective series of calculations? And some way of a unitary calculation or some calculation like that is the only way that I know of to assure that firms that operate solely in one State are taxed on exactly the same basis as firms that operate in several States or nations.

Senator CHAFEE. Well, we have a fundamental disagreement in that respect. Senator Baucus.

Senator BAUCUS. Mr. Chairman, I would like to ask John a question. Maybe I don't fully understand what the State does. Let's assume two hypothetical corporations. They are identical—in the proportion of business, in the proportion of assets, and R&D, and so forth, that they do in Montana and in other States and in respect to other countries. They are identical.

The only difference is that corporation A is a U.S. based corporation, and corporation B is a foreign-based corporation. Does the State of Montana tax either corporation A or corporation B differently or the same?

Mr. LAFAVER. You use the same calculation; and if everything were equal, exactly the same tax would be paid, but the factors that would be applied to the foreign firm, since you are applying to a smaller tax base, would be larger.

Senator BAUCUS. Everything is the same. Everything is equal.

Mr. LAFAVER. All right. If everything is equal——

Senator BAUCUS. They are absolutely identical.

Mr. LAFAVER. They will pay exactly the same tax to the State.

Senator BAUCUS. Then, I misunderstand. I thought that we were working on the assumption in the discussion that the foreign-based corporation would be subject to less than the U.S.-based corporation, at least that is Mr. Hurston's——

Mr. LAFAVER. No, no.

Mr. HURSTON. That is not a correct description of what happens at all. If Toyota had a very profitable operation in the United Kingdom and Ford Motor Co. also had a very profitable operation in the United Kingdom—their most profitable operation in the world—the method they would tax Ford on would create a much larger tax liability for the Ford Motor Co. than it would to Toyota because they had included that United Kingdom profitable operation in their tax base, no matter what kind of formula.

The formula that is applied by Montana is that would in fact produce that result because they have included the overseas operation in the tax base of the Ford Motor Co. and not in the tax base of Toyota.

Senator CHAFEE. That is the way I understood it.

Mr. HURSTON. That is the way it works.

Senator BAUCUS. Do you have a response, Mr. LaFaver?

Mr. LAFAVER. Under the example that you had, you would have higher factors on the foreign firm since you would not be using the foreign parent factors. For the domestic firm, you would be using all factors, and so they would be smaller; but the tax bill would be paid—if everything else is equal—the tax bill that they would pay would be exactly the same. And that is just the way it works.

Senator BAUCUS. I am not crystal clear on that.

Mr. HURSTON. Then why do they do it?

Senator CHAFEE. We have got to wind this up. We have got to be out of this room at 11:30, and we have another panel of five witnesses. Have you got a quick question?

Senator BAUCUS. No. Fine, Mr. Chairman.

Senator CHAFEE. Thank you all very much for coming. Would the next panel please move rapidly into position? Mr. Harry Corless, chairman, ICI Americas; Mr. J. Thomas Johnson, president, National Association of Tax Administrators and director of revenue for the State of Illinois; Mr. Robert McNeill, executive vice chairman, Emergency Committee for American Trade, ECAT; and Mr. Thomas DuBos, tax legislative counsel, Mobil Corp. All right. Why don't we start in order? Mr. Harry Corless.

STATEMENT OF HARRY CORLESS, CHAIRMAN, ICI AMERICAS, INC., WILMINGTON, DE, ON BEHALF OF THE ORGANIZATION FOR FAIR TAXATION OF INTERNATIONAL INVESTMENTS

Mr. **Corless**. Mr. Chairman, my name is Harry Corless, chairman of ICI Americas. I will try to read this rather quickly and keep to your time schedule. I am appearing on behalf of 24 U.S. companies that comprise the Organization for Fair Taxation of International Investments.

Senator **Chafee**. Now, wait a minute. Don't go too fast or we can't understand you. [Laughter.]

Mr. **Corless**. The foreign accent may baffle you as well, Mr. Chairman, but I will try to slow it a little. Our members represent foreign investments in the United States which have generated more than 130,000 jobs; that is direct labor employment. In addition to that, we estimate a similar number of dependent jobs. We support S. 1974, and we would urge its prompt enactment because it will do three things which are badly needed. It will end the chaos that exists amongst the States with respect to income taxation of multinational companies, and it will ensure uniform application of a taxation system that is accepted as an international norm. It will put foreign multinationals on an income tax parity with U.S. domestic multinationals.

And after the discussion that took place on the last panel, I think you would agree that that would be an advisable thing to do. It will put an end to years of litigation and permit the Federal Government to speak with one voice in an area of foreign commerce that cries out for uniform rules and orderly administration. It will thus avoid the threat of foreign retaliation. Because S. 1974 is designed to achieve these ends, it will encourage investments in the United States and promote reduction of the growing U.S. trade deficit.

These objectives cannot be achieved without Federal legislation. The States themselves have asked for Federal assistance in obtaining information in order to assess their own income taxes correctly on multinational groups. S. 1974 not only provides such assistance—it was referred to as multilisting earlier—it also tells the States that they may not burden the commerce of the Nation to the detriment of all of its citizens by unreasonable tax rules that interfere with and in some cases defeat the foreign commercial policies of the Federal Government.

Not all States, to be sure, engage in these practices; but enough have in the past and continue to do so at present to make federally mandated uniformity a necessity for the benefit of the whole Nation. We believe, in fact, that S. 1974 will prove sufficiently beneficial to those remaining States that employ worldwide unitary taxation that any temporary revenue losses from its abandonment should eventually be offset by increased efficiency in collection and greater investments from foreign and domestic sources.

Some of our members are individually litigating the unitary tax issue in court. My company is one of those. If Senator Baucus was still here—where angels fear to tread perhaps as a foreign national—I would just take one word with regard to the constitutionality of the whole system. The Supreme Court has only ruled with respect to domestic multinationals. The question is still open as to foreign multinationals and is presently being litigated.

We do not accept that the recent California legislation on this subject is an answer. It does not repeal unitary taxation; it imposes substantial fees for those who wish to take a 10-year gamble that the profitability from U.S. operations would be less than the profitability from foreign operations.

Don't forget that this is not the only form of taxation: There are two alternatives. It is either arm's length taxation or it is unitary taxation, not both. In addition, if the authorities don't like the result, they have the unilateral right, based on some unclear criteria, to declare that there has been evasion of taxation and thus repeal the election that has been made by the corporation.

It is not only poor tax policy; it is pure extortion that shouldn't be countenanced in this country.

Senator CHAFEE. All right. Thank you very much. Right on schedule. Mr. Johnson.

[The prepared written statement of Mr. Corless follows:]

STATEMENT OF HARRY CORLESS,

CHAIRMAN OF

ICI AMERICAS INC.,

ON BEHALF OF

ORGANIZATION FOR FAIR TAXATION OF INTERNATIONAL INVESTMENTS

BEFORE THE UNITED STATES SENATE COMMITTEE ON FINANCE

CONCERNING

S. 1974

"THE UNITARY TAX REPEALER ACT"

ON

SEPTEMBER 29, 1985

My name is Harry Corless. I am Chairman of ICI Americas Inc., a Delaware corporation, and I am appearing today to testify on behalf of the Organization for Fair Taxation of International Investments ("OFTII"). OFTII is composed of twenty-four United States subsidiaries of foreign corporations. A list of member companies, showing the nationalities of their foreign parent companies is annexed.

OFTII members have invested billions of dollars in the United States and have created many jobs here as a result of that investment. My own company, ICI Americas, has investments valued at a billion and a half dollars in the United States and presently employs more than 12,000 Americans at major facilities in ten different States. We are the third largest employer in our home State of Delaware. A recent survey of thirteen OFTII members showed aggregate investments in excess of $10.5 billion and employment of over 130,000 workers in the United States. OFTII members represent the counterbalance to "runaway" exporting of jobs and investments to foreign countries. Our organization is not seeking favored treatment for our investments. OFTII is dedicated to achieving equal treatment for investments in the U.S. that promote U.S. prosperity. OFTII members have been especially penalized by some States' imposition of worldwide unitary taxation because it taxes us on revenue that has no connection with our investments or operations, or even with the United States. Stated otherwise, OFTII members pay a disproportionate share of State taxes under worldwide unitary apportionment since it taxes the income from our parent companies' investments elsewhere.

OFTII's opposition to worldwide unitary taxation arises from the fundamental premise that our very existence depends on foreign investment in the U.S. We are domestic enterprises, creating domestic products using domestic facilities, and employing domestic labor. Worldwide unitary taxation penalizes and discourages these kinds of investments. In the case of multinational companies, worldwide unitary taxation encourages running foreign operations at a lower level of profitability than domestic enterprises in order to reduce apportionable net income subject to tax here. From both an investment and an operations standpoint, therefore, worldwide unitary taxation runs against the economic interests of the United States.

OFTII strongly supports S. 1974 and the corresponding House measure, H.R. 3980. This Bill, while requiring a few technical changes, offers a practical and viable solution to the worldwide unitary tax dilemma. The Bill further provides the States access to information and resources needed for a proper assessment of State income taxes that they do not now have. Recent legislation in California does not allay the major concerns of OFTII about worldwide unitary taxation. S. 1974 is needed, and it is needed now.

The States are not able to deal adequately with the issues of international income taxation for both practical and political reasons. The States are not empowered to deal with foreign governments with respect to such important tax matters as information exchanges; reciprocal transfer pricing adjustments; foreign tax credits; sourcing of income rules; and the many other subjects that are addressed by federal treaties and the international operations of the United States Treasury. Without federal legislation, it is not possible to achieve a fair and uniform method of taxing international investments within the United States. A number of States utilize tax methods that prevent the Federal Government from "speaking with one voice" in international affairs and that create a substantial risk of international multiple taxation for foreign companies. These two effects have been held by the Supreme Court in Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979), to make such methods unconstitutional.

Some OFTII members are now actively contesting State worldwide unitary taxes in both State and federal courts. The Department of Justice has filed an amicus brief in these cases declaring unequivocally that worldwide unitary taxation by a State is "clearly unconstitutional." The President, the Secretary of State, and the Secretary of the Treasury have condemned worldwide unitary taxation by the States. Federal legislation now will provide a rational and uniform basis for State taxation of international businesses. Federal legislation now will permit an end to the international friction, threats of foreign retaliation, and years of lawsuits needed to settle this vexatious problem piecemeal through repeated litigation and appeals to the Supreme Court. Reliance on the States to address the worldwide unitary tax situation is not adequate. Tax laws and attitudes among the States differ widely. Once the public attention to this issue has subsided, there will be a great temptation for individual States to revert to worldwide unitary taxation to make up budget deficits. This would force OFTII and others to engage again in a State-by-State effort to achieve repeal -- a time-consuming, expensive, and very frustrating effort. Federal legislation is less subject to local attitude changes and provides a comprehensive method of dealing with issues of foreign commerce, as contemplated by the Constitution.

The legislation recently enacted by California does not abolish that State's unitary income tax and does not provide a sufficient answer to the important issues of State unitary taxation that are addressed in S. 1974. The obvious shortcomings of the California law are:

1. There are other States that fully retain worldwide unitary taxation.

2. The California law does not actually repeal worldwide unitary taxation but provides an "election" upon payment of a fee in addition to the taxes normally imposed upon U.S. business operations properly subject to tax by that State. In other words, one is required to pay a fee, based on payroll, property, and sales factors to be allowed to escape the worldwide unitary tax that is likely unconstitutional in the first place. This fee is set at an annual amount of .03% of those three factors for a ten year interval, irrespective of the amount of the taxpayer's taxable income.

3. The foreign parent company making the investment in the U.S. is, in effect, required to submit itself to the jurisdiction of the California Franchise Tax Board for the purposes of audit, but is not granted access to the courts of California for the purpose of litigating the correctness of any tax imposed.

4. The California Franchise Tax Board may break the ten year contract and ignore the taxpayer's "water's edge" election under vague criteria, presumably to be amplified by the Board's own regulations. Past experience of OFTII members with the Franchise Tax Board does not make this an encouraging prospect.

5. The legislation does not take effect until 1988 and there are already indications of detrimental changes to be made before the effective date. No provisions at all is made for settling existing worldwide unitary tax disputes that cover, in many cases, more than 15 years of audits.

The California legislation may benefit some companies whose taxes have been grossly distorted under the existing system. The new law, however, is mostly genuflection designed to relieve the extreme pressure for action that has been put upon the Federal Executive by numerous foreign governments. But there is no way to predict how the new "election" will work in practice; whether the fee will be increased in future years to meet revenue needs; or whether regulations will make the whole scheme completely unpalatable. These issues and many others can and should be resolved now by a comprehensive federal law that defines the limits of State authority; prescribes a uniform method of information disclosures; defines who is the taxpayer over whom State authorities may exercise jurisdiction; imposes federal penalties for non-compliance that do not simply reinstitute unitary taxation at the discretion of the State; and addresses the many lesser issues of compliance, reporting, disclosure, and audit that are created by disparate tax laws among the States. We believe that, in the main, S. 1974 will accomplish those objectives when enacted. We believe that final resolution of the unitary tax problem along the lines of S. 1974 will encourage economic growth in the United States. Among other things, it will make it possible for a chief executive officer in a domestic company to locate new enterprises in areas of the United States without worrying whether the directors of a related foreign enterprise may make an investment in Malaysia or Italy that will increase the U.S. company's domestic taxes!

Turning to the details of the Bill, the following proposals for improvement are submitted for your consideration:

In General.

The Bill should distinguish between imposition of worldwide unitary taxation "downstream" to include the foreign subsidiaries of a domestic parent and "upstream" to include the foreign parent of a domestic subsidiary. The power of a State to impose worldwide unitary taxation is established in case law only as it applies to domestically based multinational groups. Container Corp. v. Franchise Tax Board, 463 U.S. 159 (1983). As applied to foreign based multinationals, worldwide unitary taxation is contrary to the position expressed by Secretary Shultz in his 30 January 1986 letter to six unitary tax State governors and to the brief filed by the Department of Justice in the pending cases in federal court.

The Bill should define who is the "taxpayer." In some State statutes, the "taxpayer" may be a worldwide group that includes a foreign parent as well as a domestic corporation. The federal legislation should avoid the implication that the "taxpayer" is a foreign based, worldwide group of corporations, irrespective of whose income may be included in a domestic entity's tax base.

The Bill should, therefore, (1) prohibit absolutely worldwide unitary taxation of foreign based multinational groups; (2) grant such relief from worldwide unitary taxation to domestic based multinational groups as the Congress sees fit; (3) impose federal penalties upon domestic taxpayers, whether foreign or domestically controlled, who fail or refuse to provide reasonably obtainable information required to prevent evasion or avoidance of State taxes; and (4) prohibit any State or State agency from seeking information directly from a foreign government or agency. All such information should be obtainable only by the IRS or the State Department and disseminated to the States. The following specific comments on the Bill's provisions conform to the foregoing general principles.

Section 7518(a).

The penalty imposition of worldwide unitary taxation in subparagraphs (1) and (2) should be altogether eliminated. Worldwide unitary taxation must not be imposed as a penalty. Monetary penalties are sufficient to force compliance where needed.

A foreign corporation not subject to tax under Internal Revenue Code ("IRC") Section 882 should not be included unless it either maintains a permanent establishment in the United States, is owned or controlled by a corporation subject to tax in the United States, or has substantial (over 20%) U.S. source income. It is recommended that the word "taxpayer" be deleted and the word "corporation" substituted since worldwide unitary taxation can only be applied to corporations and combined groups of corporations.

Section 7518(c).

There should be added to paragraph (1) "gross receipts," "net profits," or "apportionable net income."

The three factor and $10 million threshold tests in Paragraph (2)(D) are not in accord with any other provisions of federal law. As worded, a foreign corporation that maintained a small purchasing office in the U.S. that did nothing but buy U.S. goods in excess of $10 million annually for its overseas operations would be subject to inclusion. This contravenes the purchasing office exception of most U.S. tax treaties. This also tends to discourage exports from the U.S., surely not a desirable objective. It is recommended that the 20% gross income test of IRC Section 861 be utilized in lieu of this provision.

Section 7518(c).

Subparagraph (3)(B) appears to subject a foreign holding company that had no U.S. source income and held no stock, directly or indirectly, in United States enterprises to State income tax. As worded, this provision does not agree with the Treasury explanation. A Netherlands holding company, for example, that holds only stock in South American companies and pays all of its dividends received to a parent in a European country, would appear to be includable since Netherlands imposes only a 5% withholding tax on dividends. This is a concept completely at odds with "water's edge" taxation and will not abate the unitary tax controversy with foreign governments. Foreign source income to be included should be based on an IRC Subpart F concept, the principles of which are now well established.

Neither is it apparent that treating a domestic corporation as a foreign corporation will accomplish the purpose stated in the Treasury explanation. The recitation of the three-factor formula used for State tax apportionment runs counter to the "water's edge" principle and should be removed. The test for inclusion in the "water's edge" group should in all cases be 20% of gross income, as in IRC Section 861, and not a three-factor/$10 million threshhold. See following comment on Section 6039A(c)(1)(A).

Section 6039A(a).

It is presumed the required report is to be made to the IRS on forms prescribed by the Secretary. Any suggestion that each State may design its own form of report should be avoided.

Section 6039A(b).

Paragraph (2) is acceptable so long as Section 7518(c)(3) is amended to eliminate foreign companies that have no business connection with, nor substantial income sourced within the United States and are not members of an affiliated group controlled by a domestic company. Neither State nor federal legislation should impose a reporting requirement on a foreign entity that does not choose to do business in or with the United States. Even in Subpart F cases, the report is made by the domestic, not the foreign company.

Section 6039A(c).

The definition of a "reporting corporation" in Paragraph (1)(A) should be amended to apply the IRC Section 861 20% gross income test instead of the three-factor/$10 million test. The assets test is particularly objectionable since it involves restating foreign assets at historical costs in terms of

U.S. currency. The compensation test is nearly as objectionable because it is not adjusted for productivity in various countries. The test assumes that $1.00 of wages paid in the U.S. produce the same results as the exchange equivalent in foreign currency paid in Japan, India, etc. This is a demonstrably erroneous assumption and is one of the chief foreign complaints about worldwide unitary taxation apportionment formulae.

Subparagraph (1)(B)(ii) attributes compensation, property and sales of foreign corporations that are members of a foreign parent "controlled group" to the U.S. subsidiary of such group. This is done, apparently, for the purpose of validating the three-factor/$10 million tests of subparagraph (1)(A). Use of the 20% gross income test in subparagraph (1)(A), makes this paragraph unnecessary and it should be eliminated.

Section 6039A(e).

Since the ability of the States to force a noncomplying corporation into worldwide unitary taxation should be eliminated, it is appropriate to increase the non-filing monetary penalties. $10,000 is recommended for paragraph (1); $5,000 should be substituted for "$1,000" in paragraph (2), and the maximum should be increased to $60,000. This should be adequate to ensure compliance. The penalty should be limited to willful or negligent conduct. Failure to provide information due to circumstances beyond the taxpayer's control, such as a legal prohibition by a foreign government on the disclosure of certain information, should not be penalized. It is presumed that information disclosure will be handled entirely at the federal level under changes proposed to IRC Section 274(h)(6)(C).

There is attached a marked copy of the relevant pages of S. 1974 reflecting changes proposed by the foregoing comments. OFTII is prepared to work with other proponents of this important legislation to pass the Bill in the 100th Congress. This Committee is urged to consider the Bill quickly and approve its major features at the very beginning of the 100th Congress so that floor action can take place promptly.

Thank you for your attention. I am at your disposal to answer questions concerning the position advocated.

Respectfully submitted,

Harry Corless

Harry Corless

STATEMENT OF J. THOMAS JOHNSON, PRESIDENT, NATIONAL ASSOCIATION OF TAX ADMINISTRATORS; AND DIRECTOR OF REVENUE, STATE OF ILLINOIS, SPRINGFIELD, IL, ACCOMPANIED BY LEON ROTHENBERG, EXECUTIVE SECRETARY, NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, WASHINGTON, DC

Mr. JOHNSON. The States' reaction to Federal legislation which would prohibit the use of the worldwide unitary method attributing income for corporate income tax purposes which would also limit the amount of foreign dividend income that could be taxed by the States is predictable. We oppose such legislation, and we oppose the infringements on States' rights.

The effort of the working group, we believe, has accomplished much in the past 2 years, much more than has been accomplished in this area in the previous 20 years. Nine of the twelve States that used this form of income apportionment have abolished its use. Three remain: Montana, North Dakota, and as you heard from Mr. LaFaver, these two will be considering legislation on this subject matter this year in all likelihood; and Alaska, it is interesting to note, once prohibited the use of worldwide combination but, because of litigation entered by taxpayers in the State of Alaska, were forced to that method of income apportionment.

Two things I would like to briefly talk about today that are included in this legislation that, under the working group agreement, was agreed, at least in the States' opinion, to be left to the States; and that is whether or not 80/20 corporations should be included in the water's edge and the subject of foreign dividends.

With the use of water's edge combination, States will become much more dependent upon the Federal Government's process of determining whether income is properly attributed to domestic activities versus foreign activities by the use of arm's length transactional adjustments in the attribution of income. The area of 80/20 corporations, because they are included in the Federal consolidated return, the Federal Government will not be as active in income attribution between foreign activities and domestic activities as they would be in those cases involving foreign corporations. And so, the concern is whether or not income will be properly attributed to domestic activities when there are 80/20 corporations involved in the Federal consolidated return.

Because of that concern, the working group felt that it would be most appropriate to deal with that issue at the State level. In the area of foreign dividends, this would not only affect—or the required exclusion of 85 percent of foreign dividends—would not only affect the three remaining worldwide unitary States, but it would affect more than half of the States that incorporate a corporate income tax in their tax structure. More than 24 States would be affected.

You could argue that requiring foreign dividend exemption and not domestic dividend exemption at the State level encourages foreign investment over domestic investment; and that is something that we believe is questionable.

And finally, there is one aspect of the legislation we obviously support, and that is the spreadsheet legislation. It is the principal element of the administrative assistance component that the working group agreed to that was necessary in order to encourage States to use other than the use of the worldwide unitary approach. We need the information. We need it so that we can properly attribute income to domestic activities; and with the reduction in the worldwide unitary method, we think it is absolutely necessary for the success of the overall working group agreement.

Thank you very much.

Senator CHAFEE. So, you are against the bill except for that provision?

Mr. JOHNSON. That is correct.

Senator CHAFEE. All right. Thank you. Mr. McNeill.

[The prepared written statement of Mr. Johnson follows:]

TESTIMONY
OF
J. THOMAS JOHNSON,
DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE AND
PRESIDENT, NATIONAL ASSOCIATION OF TAX ADMINISTRATORS

ON

THE IMPOSITION BY STATES OF THE WORLDWIDE UNITARY METHOD OF TAXATION

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE OF FINANCE

UNITED STATES SENATE

September 29, 1986

TESTIMONY

The states' reaction to federal legislation which would prohibit the use of the worldwide unitary method in attributing income for corporate income tax purposes and which also would limit the amount of foreign dividend income that could be taxed by the states is predictable. It has not changed over several decades. The states' perspective on this legislation is the same as it would be on any other proposal which would limit the rights of the states to raise revenues beyond those limitations which are required by the Constitution. We are opposed to such infringements on states' rights. The right of a state to structure its tax system -- and to raise revenue in a manner that is free of federal interference -- is a right that the states have jealously guarded over the years.

I understand the committee is receiving testimony on both S. 1113 and S. 1974 today. I will devote my comments to the specific provisions of S. 1974. Although the limitation of which corporate entities must be excluded in an acceptable combined apportionment method and what portion of foreign dividends cannot be taxed by the states varies to some extent between the two proposals, S. 1113 limits the states' rights to raise revenue in basically the same manner.

One thing that is particularly troubling about S. 1974 is that it is based on the work done by Treasury's Worldwide Unitary Taxation Working Group. As you know, the Working Group was created in 1983 shortly after the U.S. Supreme Court upheld California's right to apply the worldwide unitary method of apportionment in the Container case. The Working Group was created because it was believed by foreign trading partners and members of the business community that the worldwide unitary method was creating an international incident and was prohibiting our national government from speaking with one voice in the area of foreign commerce.

Secretary Regan charged the Working Group "with producing recommendations...that will be conducive to harmonious international economic relations while also respecting the fiscal rights and privileges of the individual states."

The Working Group was made up of leaders from the business world, state government, and the federal government. A staff task force was created to gather testimony and to evaluate various options for the Working Group. I was privileged to serve as a member of the Task Force.

The state representatives on both panels agreed to adopt the water's edge combination method with the understanding that it would be implemented by state action rather than federal restrictive legislation. The agreement to consider voluntary state action was made under certain conditions, the most significant being quick action on implementing those proposals which provided "increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability".

Secretary Regan's "Chairman's Report on the Worldwide Unitary Taxation Working Group" suggested that the states should be given the opportunity to solve this problem and suggested that restrictive federal legislation should only be considered if there was not "sufficient signs of appreciable progress". It was also proposed that in order to encourage the states to act quickly the Treasury Department should move "immediately to implement the federal assistance measures recommended by the Working Group to promote full disclosure and accountability".

The Working Group report was issued just two years ago, and in that time, nine (9) of the twelve (12) states, including California, that used worldwide unitary prior to the Working Group's deliberations have changed their laws -- and the remaining three states are giving it serious consideration. We believe this to be relatively swift action especially in light of the fact that few of the federal assistance actions agreed to are yet in place and available to the states. A federal solution to the worldwide unitary problem is not something that was recommended by the Working Group. And, in light of the relatively quick change by most of the states, a federal solution is not something that can be portrayed as the only alternative.

In addition to prohibiting the use of the worldwide method, this legislation addresses two additional issues that may be considered of even greater concern to the states.

First, the bill limits the way in which a state can tax dividends paid by foreign corporations. A state would have to exclude from its tax base either 85 percent of the dividends, or that portion of the dividend that effectively bears no federal income tax by reason of the foreign tax credit, or some other method that is permitted by federal regulation.

A recent survey by the National Association of Tax Administrators (attachment 1) shows that, of the 45 states and the District of Columbia that have an income tax, 24 of them will be affected by these limitations. Twelve of the fourteen states that have no exemption for foreign dividends would be affected. (The remaining two would be unaffected because they allocate dividends to the commercial domicile.) Twelve additional states would have some impact because the exemptions currently provided are not as expansive as would be required by the federal proposal. So this legislation not only affects the current practices in three wouldwide unitary states but over half of the states that impose a corporate tax based on income.

The other limitation, whose effect we have not measured, relates to corporations that have at least 80 percent of their property, payroll and sales located outside the United States. This limitation would affect combined reporting states that claim a right to include all U.S. corporations in a unitary business, even though more than 80 percent of their apportionment factors are outside the U.S.

The states feel strongly that these two issues should be left for resolution at the state level. As indicated in the Chairman's letter transmitting the Working Group report to the President, the state and business representatives were unable to reach an agreement on the proper state tax treatment on these issues and therefore left them for resolution at the state level.

One could argue that failure to include "80/20 corporations" in the unitary group or requiring the exemption of foreign dividends from taxation would be favoring foreign investment over domestic investment and giving preferential treatment to international businesses as compared to wholly domestic businesses. One could hardly argue that federal restrictions in these two areas are necessary to solve the problems of our foreign trading partners.

There is one feature of this legislation that the states support, and that is the provision for the domestic disclosure spreadsheet. The spreadsheet could have a dramatic effect on state tax administration. However, it was not intended to be a component of restrictive federal legislation. It was supposed to be a separate piece of legislation that provided assistance to those states that voluntarily refrained from using the worldwide approach and therefore would encourage swift state action.

In addition, the language of the federal proposal does not expressly provide for the type of spreadsheet that was developed and tested by the Working Group. Instead, the language is vague, and it would lead to disputes over interpretation during the drafting of regulations. Last fall, NATA sent a letter (attachment 2) to the Treasury Department which suggested explicit language. We believe such a clarification on what information was required would avoid unnecessary disputes.

As envisioned by the Working Group, the purpose of the spreadsheet is to help identify underreporting or inconsistent reporting of income. Parent corporations and more than 50 percent owned subsidiaries would have to show, for each state in which they operate, their taxable income, their business and nonbusiness income, their apportionment factors, and whether they filed on a combined, consolidated or separate basis.

A review of the spreadsheet information could show a number of things which will be of benefit to all of the states that impose a corporate income tax. It will identify possible nonfilers; companies that apportion income in one state and allocate that same income in other states; apportionment factors that do not add up to 100 percent with no explanation given; and inconsistent treatment of unitary groups or the effect of leaving a company out of a unitary group.

Another point that was made clear in the working group report was that the spreadsheet would be filed with the IRS, and would then be given to a designated agency. This agency would conduct some review and make audit referrals. It would also supply copies of the spreadsheets to eligible states upon request. The designated agency provision does not exist in this legislation.

In closing, an international problem faced our national government two years ago and the states have responded. It was agreed that specific assistance programs were to be made available to the state by the federal government to encourage the states to take that action. We are still waiting for those measures today.

Attachment 1

STATE TAXATION OF FOREIGN-SOURCE DIVIDENDS

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Research Report 113, July 1986

STATE TAXATION OF FOREIGN-SOURCE DIVIDENDS

Late in 1983, NATA surveyed the states on their practices with respect to the taxation of foreign-source dividends. The results were published in FTA Research Memorandum 561, STATE TREATMENT OF FOREIGN-SOURCE DIVIDENDS (March 1984). Since that time, there have been several developments in this important area, including the introduction of a Treasury bill (S. 1974 and H.R. 3980) on December 18, 1985 to prohibit the worldwide unitary method, and to restrict state taxation of foreign-source dividends.

The Treasury Bill: Prohibiting Use of Worldwide Unitary Method

The Treasury bill would bar "worldwide" combination and substitute "water's-edge" combination. Under worldwide combination, formula apportionment and the combined report include all activities of a unitary business, including activities in foreign countries. A share of the combined income is assigned or apportioned to the worldwide unitary tax state on the basis of relative levels of business activity of the combined group. The four states[1] which have worldwide combination laws are: Alaska, California, Montana, and North Dakota.

The status of worldwide combination laws in these four states are:

Alaska: A bill has been introduced to use separate accounting rather than the worldwide unitary method in the case of oil and gas companies. Alaska used this method for several years and switched to worldwide combination because of uncertainty of the outcome of litigation, which has since been resolved in favor of the state.

California: Bills to revise California's worldwide unitary method of taxation have been principal matters on the legislative agendas at the 1986 sessions of both the Assembly and the Senate.

Montana: The legislature does not meet in 1986. However, the Governor of Montana has recommended shifting from worldwide combination to water's-edge, and the legislature has assigned the issue for interim study.

North Dakota: The legislature does not meet in 1986. During the 1985 legislative session, the legislature adopted a resolution directing the Legislative Council to study the issue with emphasis on the Worldwide Unitary Taxation Working Group and to report its findings and recommendations to the 1987 legislature.

Under the water's-edge view, formula apportionment and the combined report include only those activities within the boundaries of the United States and its territories. Under this method, prices between the foreign and domestic entities of a unitary business are set at "arm's-length"--the pricing mechanism employed under separate accounting. Where transactions with unrelated parties do not exist, the prices of transactions between corporations under common ownership are constructively determined as if the corporations were unrelated.

The Treasury bill would effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States (the water's-edge requirement). The bill prohibits the use of the worldwide unitary method unless (1) the taxpayer fails to comply with certain spreadsheet information requirements, or (2) fails to provide material information relating to the determination of its tax or relating to transactions between the taxpayer and a corporation which is a member of the same controlled group. "Pursuant to an unconditional election by such taxpayer," however, states may permit taxpayers to be taxed on a worldwide unitary basis.

Restrictions on State Taxation of Foreign-Source Dividends

In taxing foreign-source dividends, the Treasury bill provides that states may include in a corporation's income base only "an equitable portion" of such dividends. States are given a choice of several methods of defining an equitable portion: (1) exempting 85 percent of dividends from these corporations, (2) excluding the portion of the dividend that effectively bears no federal income tax after application of the foreign tax credit, or (3) other methods to be described in the regulations that result in an apportionment of dividends to the state substantially similar to methods (1) and (2).

This report summarizes the states' current treatment of foreign-source dividends and the findings of the NATA survey of the estimated revenue impact of Treasury's proposal to limit state taxation of foreign-source dividends.

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[1] Although Idaho currently employs worldwide combined reporting, legislation was recently enacted which will allow qualified corporate taxpayers to elect to use a water's-edge combined reporting method beginning in 1988 (or possibly in 1987 if a federal domestic disclosure requirement is enacted in 1986). In this report, Idaho will be treated as a water's-edge state and not as a worldwide combination state.

Current State Taxation of Foreign-Source Dividends

Table 1 shows that fifteen states wholly-exempt foreign-source dividends from income tax, fifteen states exempt them in part, and in fifteen states, such dividends are taxable income. Of the remaining six states, five (Nevada, South Dakota, Texas, Washington, and Wyoming) do not levy a corporate income tax. Michigan, which imposes a single business (value-added) tax, allows a subtraction from the tax base for dividends received.

States Exempting Foreign-Source Dividends

The following fifteen states exempt all foreign-source dividends: Arizona, Connecticut, Delaware, Florida, Georgia, Hawaii, Kentucky, Minnesota, Mississippi, Missouri, Nebraska, Ohio, Pennsylvania, Virginia, and West Virginia. Since the 1983 NATA questionnaire, six of these states have changed their tax treatment of foreign-source dividends. Five states- Arizona, Hawaii, Minnesota, Florida, and Nebraska--moved to a position of total exemption, and one state--West Virginia, expanded its tax base to include a portion of these payments.

Formerly, Arizona, Hawaii, and Minnesota partially exempted these items while Florida and Nebraska considered them to be taxable income to the payee corporation, subject to allocation and apportionment. In contrast, West Virginia, which wholly-exempted foreign-source dividends at the time of the 1983 survey, amended its law to provide for the inclusion of these payments, to the extent they are included in federal taxable income, for tax years beginning after July 1, 1987.

States Partially Exempting Foreign-Source Dividends

The following fifteen states partially exempt foreign-source dividends by statute: Alabama, Arkansas, Colorado, Illinois, Maryland, Massachusetts, New Jersey, New York, North Carolina, Oregon, Rhode Island, South Carolina, Tennessee, Utah, and Wisconsin.

Six of these states automatically exclude a certain proportion of dividends--New Jersey, 50 percent; New York, 50 percent; Utah, 50 percent[2]; Illinois, 85 percent; Oregon, 85 percent; and South Carolina, 85 percent. In cases where the payee corporation owns the requisite percentage of stock in the payor corporation, such dividends are totally exempted from taxation in twelve of these fifteen states: Alabama, Arkansas, Illinois, Maryland, Massachusetts, New Jersey, New York, North Carolina, Rhode Island, South Carolina, Tennessee, and Wisconsin.

Both types of exclusion--automatic and total, if certain proportions of payee stock ownership in the payor corporations are met--are provided under the taxing schemes in four of these states: Illinois, New Jersey, New York, and South Carolina. In a few states, an exemption for dividends depends on factors in addition to stock ownership. The rules for exemption of foreign-source dividends in effect in these fifteen states are set out below:

Alabama: The treatment accorded dividends of affiliated companies owned 50 percent or more by payees under Section 40-18-35(14), Code of Alabama 1975, as amended, is that of a deduction from gross income. All dividend income is taxable income, but will be subject to allocation, apportionment, or deduction.

Arkansas: Dividends are exempt if the payee owns 95 percent or more of the payor.

Colorado: Beginning with 1986 tax years, the amount of foreign-source income, including dividends, excludible by a taxpaying corporation depends on whether the taxpayer elects the federal foreign tax deduction or the foreign tax credit. If the deduction is elected, Colorado will consider all foreign-source income, less the deduction, to be taxable income. If the credit is elected, the proportion to be excluded from Colorado taxable income is the ratio of the foreign taxes paid or accrued to 46 percent (the maximum federal corporate income tax rate) of the foreign-source income. In other words, the foreign-source income is to be excluded to the extent the foreign taxes paid by the taxpayer are less than the federal taxes it would have paid had the income been U.S. income.

Illinois: All dividends are 85 percent excluded. Dividends are fully exempt if the payee and its affiliates own 80 percent or more of the payor.

Maryland: Dividends are exempt if the payee owns 50 percent or more of the payor.

Massachusetts: Dividends are exempt if the payee owns 15 percent of the payor.

New Jersey: All dividends are 50 percent excluded. Dividends are fully exempt if the payee owns 80 percent of the payor.

New York: All dividends are 50 percent excluded. Dividends are fully exempt if the payee owns 50 percent or more of the payor.

North Carolina: Corporations domiciled in North Carolina may deduct dividends received from payors of which they own 50 percent or more.

Oregon: All dividends are 85 percent excluded.

Rhode Island: Rhode Island taxable income does not include the gross-up of dividends required by the federal Internal Revenue Code to be taken into taxable income in connection with the taxpayer's election of the foreign tax credit, or special deductions on line 29(b) of federal form 1120.

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[2] Other exclusions may also apply. See page 3.

South Carolina: All dividends are 85 percent excluded. Dividends are fully exempt if the payee and its affiliates own 80 percent or more of the payor.

Tennessee: Dividends are exempt if the payee owns 80 percent or more of the payor.[3]

Utah: The following dividends received from foreign subsidiary or affiliated corporations are excluded from Utah gross income: (1) 50 percent of dividends from an affiliate or subsidiary organized or incorporated outside the United States [100 percent of dividends deemed received under section 951 of the Internal Revenue Code (relating to amounts included in gross income of U.S. shareholders)] are excluded if the payor's income is included in a combined report with the recipient; (2) dividends from any foreign operating company or tax haven corporation; (3) dividends from any affiliate or subsidiary engaged in a business that is not unitary with that of the taxpayer or whose income is included in a combined report with the recipient; and (4) any foreign dividend gross-up under section 78 of the Internal Revenue Code (relating to dividends received from certain foreign corporations by domestic corporations choosing a foreign tax credit).

Wisconsin: Dividends are exempt if the payee owns 80 percent or more of the payor.

States Treating Foreign-Source Dividends as Taxable Income

The following fifteen states consider foreign-source dividends to be taxable income to the payee corporation, subject to allocation or apportionment: Alaska,[4] California, Idaho, Indiana, Iowa, Kansas, Louisiana, Maine, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, Vermont, and the District of Columbia.

Four of these states employ worldwide combination in the apportionment of a taxpayer's income, and include foreign affiliates as part of a unitary business group: Alaska, California, Montana, and North Dakota. These states eliminate from taxable income those dividends paid by one member of the group to another member.

Foreign Tax Credit

The following nine states do not allow a foreign tax credit as federal law does: Alaska, Colorado, Iowa, Kansas, Maine, New Mexico, Oklahoma, Rhode Island, and Vermont. These states permit the federal exclusion for dividends paid to the taxpayer by a related or wholly-owned domestic company, but permit no such exclusion for dividends paid by a corporation organized outside the United States.

Allocation and Apportionment of Foreign-Source Dividends

Of the thirty states that currently include some or all foreign-source dividends in the tax base, five states allocate all taxable foreign-source dividends to the commercial domicile of the taxpayer, nine states apportion all taxable foreign-source dividends, and sixteen states allocate some foreign-source dividends to the payee's domicile and apportion the remainder.

Three of the five states which allocate all taxable foreign-source dividends partially exempt or conditionally exclude these payments, and two states consider them to be taxable income to the payee corporation. Of the nine states which apportion all taxable foreign-source dividends, a more pronounced division results: six states conditionally exempt or partially exclude these payments, and three states consider them to be taxable income. In contrast, in the category of states which allocate some foreign-source dividends and apportion others, ten of these sixteen states consider foreign-source dividends to be taxable income and six states conditionally exempt or partially exclude them.

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[3] Except for corporations whose business is investments, dividend income would be considered nonbusiness income not subject to the Tennessee excise tax even though the corporation from which the dividend was received was less than 80 percent owned. The only cases in which dividend income would be subject to the Tennessee excise tax would be cases in which the payee corporation's principal business activity is investments and the payee corporation does not own at least 80 percent of the payor corporation, or cases in which the payee corporation owns less than 80 percent of the payor corporation and the payee corporation is commercially domiciled in Tennessee so that nonbusiness dividends are directly allocated to Tennessee and fully subject to the excise tax.

[4] Some foreign-source dividends may be excluded as being nonbusiness income, while others are excluded by virtue of coming from companies included in the combination. For years prior to 1985, intercompany dividends from companies included in the combination were excludable to the extent that current year income of the payor corporation was included in the combination. After January 1, 1985, intercompany dividends from companies included in the combination are excluded from apportionable income.

The thirty states which allocate, apportion, or allocate and apportion foreign-source dividends are shown in Table 3.

Changes in State Treatment of Foreign-Source Income Since 1983

Since the 1983 MATA survey on state practices with respect to the taxation of foreign-source income as it relates to the proposed Treasury legislation, fourteen states have changed their treatment: Arizona, Colorado, Florida, Hawaii, Idaho, Indiana, Massachusetts, Minnesota, Nebraska, New Hampshire, Oregon, South Carolina, Utah, and West Virginia. In summary, these changes are:

Arizona: Legislation enacted in 1985, and made retroactive to 1984 tax years, exempted foreign-source dividends. In the past, these dividends were exempt if the payee owned or controlled, directly or indirectly, 50 percent or more of the voting stock of the payor corporation. All taxable foreign-source dividends were apportioned.

Colorado: Legislation enacted in 1985 and effective in 1986 repealed worldwide combination in Colorado, and allowed the partial exclusion of foreign-source dividends described above. (See section on "States Partially Exempting Foreign-Source Dividends.") By this legislation, the state changed its procedure from worldwide combination to water's-edge. Dividends had formerly been considered taxable income, to be apportioned or allocated depending on their nature.

Florida: Legislation enacted in 1984 and effective with 1984 tax years exempted foreign-source dividends and repealed Florida's worldwide combination law. By this legislation, the state returned to the separate reporting requirements that were in effect before worldwide combination was enacted by 1983 legislation. In the past, foreign-source dividends were considered as fully taxable income, to be allocated or apportioned depending on whether they were business or nonbusiness income. Florida permitted domestic dividends to be excluded according to the federal provisions, but allowed no similar exclusion for foreign-source dividends.

Hawaii: Act 53, Session Laws of Hawaii-1984, proclaimed the intent of the legislature with respect to the use of the worldwide unitary method of taxing multinational companies. The Act directed the Department of Taxation not to use or allow the use of the worldwide method of unitary taxation. In essence, the department would observe the water's-edge method. Since July 1, 1984, Hawaii has chosen not to tax foreign-source dividends earned by multinational companies. Formerly, dividends were 85 percent excluded if the payor was 95 percent owned by companies doing business in Hawaii, or if 15 percent or more of the payor's business was in Hawaii.

Idaho: Legislation enacted in 1986 will allow qualified corporate taxpayers to elect to use a water's-edge combined reporting method beginning in 1988 (or possibly in 1987 if a federal domestic disclosure requirement is enacted in 1986). The legislation exempts 85 percent of foreign-source dividends, and requires that the remaining 15 percent be apportioned. In the event that no domestic disclosure spreadsheet requirement is mandated by federal law, the Idaho legislation will require similar information to be filed with the Idaho State Tax Commission. Under current law, foreign-source dividends, exclusive of section 78 gross-up, are taxable when either allocated or apportioned to Idaho.

Indiana: The 1985 General Assembly passed legislation bringing Indiana in line with the Treasury proposal with respect to worldwide unitary. As a result of this legislation, Indiana may not require inclusion of a foreign corporation or a foreign operating corporation (80-20 corporation) in a combined report. Taxpayers, however, are permitted to voluntarily elect the worldwide unitary method with prior approval of the Department of Revenue. (Worldwide combination had in fact been little used in Indiana.)

Massachusetts: By judicial decision, the Massachusetts requirement for worldwide combination was eliminated. On December 11, 1984, the Massachusetts Supreme Judicial Court held in *Polaroid Corporation & Others v. Commissioner of Revenue* that the Department of Revenue lacked the statutory authority to apportion the income of a group of affiliated companies according to the unitary method of apportionment. Even before this decision, however, worldwide combination in Massachusetts did not include the foreign parents of taxpayer corporations.

Minnesota: Minnesota exempted foreign-source dividends by 1984 legislation, effective in 1984. In the past, Minnesota had allowed an 85 percent exclusion for dividends, and had apportioned the remainder.

Nebraska: Nebraska exempted foreign-source income, including dividends, by 1984 legislation, effective with 1984 tax years. Before 1984, Nebraska had considered foreign-source dividends as taxable income, to be allocated or apportioned according to the unitary/nonunitary test. The state had allowed the federal exclusion for domestic dividends but not for foreign dividends.

New Hampshire: Effective July 1, 1986, applicable to returns and taxes due on account of taxable periods beginning after June 30, 1986, legislation was enacted in New Hampshire repealing worldwide combined reporting. The legislation amended prior law by limiting the application of the state's business profits tax to the water's-edge by eliminating overseas business organizations from subjection to this tax. Foreign-source dividends are apportioned utilizing a special formula only for tax years which begin after June 30, 1986.

Oregon: Oregon repealed worldwide combination by 1984 legislation, and instituted an 85 percent exclusion for foreign-source dividends that is effective for tax years starting in 1986. In the past, these dividends were considered fully taxable.

South Carolina: By 1985 legislation, effective in 1985, South Carolina adopted basic conformity with federal tax law, including the federal treatment of foreign-source dividends. In the past, South Carolina exempted dividends received from payors 80 percent or more owned by the payee, but allowed no general 85 percent exclusion.

Utah: By 1986 legislation, effective for tax years beginning after 1985, Utah adopted water's-edge combined reporting. The following dividends received from foreign subsidiary or affiliated corporations are excluded from Utah gross income: (1) 50 percent of dividends from an affiliate or subsidiary organized or incorporated outside the United States [100 percent of dividends deemed received under section 951 of the Internal Revenue Code (relating to amounts included in gross income of U.S. shareholders)] are excluded if the payor's income is included in a combined report with the recipient; (2) dividends from any foreign operating company or tax haven corporation; (3) dividends from any affiliate or subsidiary engaged in a business that is not unitary with that of the taxpayer or whose income is included in a combined report with the recipient; and (4) any foreign dividend gross-up under section 78 of the Internal Revenue Code (relating to dividends received from certain foreign corporations by domestic corporations choosing a foreign tax credit). In addition, factor relief is provided for the inclusion of foreign-source dividends.

A corporation required to file a combined report, however, may elect to file a worldwide combined report. Once worldwide combined reporting is elected, the group can file on another basis only with the consent of the state and a showing of significant change of circumstances.

Formerly, Utah had employed the worldwide method of unitary taxation, and included foreign-source dividends in the tax base.

West Virginia: By 1985 legislation, dividends received, to the extent included in federal taxable income, will be taxable in West Virginia as of July 1, 1987. Foreign-source dividends are currently exempted from taxation.

In summary, ten of the fourteen states which changed their treatment of foreign-source income as it relates to the proposed Treasury legislation limited their taxation of foreign-source dividends by exempting or excluding these payments in whole or in part. Five states--Arizona, Florida, Hawaii, Minnesota, and Nebraska--moved to a position of total exemption, while five other states--Colorado, Idaho, Oregon, South Carolina, and Utah--amended their laws to automatically exclude a portion of these payments. Only one state, West Virginia, took legislative action to expand its taxation of foreign-source dividends, and it did so by conforming the state's taxation of foreign-source dividends to the Treasury proposal. In addition, legislation in New Hampshire and Utah provide factor relief for includible foreign-source dividends. Further, since the 1983 NATA survey, nine states have repealed worldwide combined reporting, eight states by statute, and one state by judicial decision.

Impact of the Treasury Proposal on State Revenues

Based upon existing laws and practices, the NATA survey requested the states to estimate the revenue loss that would result from implementation of the Treasury proposal to restrict state taxation of foreign-source dividends. The revenue impacts are summarized below:

Significant revenue impact. Fourteen states estimated that they would lose revenues as a result of the proposed federal restrictions on state taxation of foreign-source dividends. (See Table 2.) Four of these states partially exclude or conditionally exempt foreign-source dividends, while the remaining ten states currently treat foreign-source dividends as taxable income to the payee corporation.

Four of these fourteen states currently employ worldwide combination and would be affected by the proposed federal prohibition against the use of the worldwide unitary method, as well as the restrictions on state taxation of foreign-source dividends. These states are: Alaska, California, Montana, and North Dakota.

Three of the four states which currently use worldwide combined reporting estimate substantial revenue losses.[5] California estimated its revenue loss at $555.0 million, while Montana and North Dakota projected a loss of 20 percent and 25 percent, respectively, of their corporate income tax collections. The estimated losses for these states reflect the full revenue impact of the move from worldwide combined reporting to water's-edge, as well as the revenue reduction from the Treasury proposal to restrict state taxation of foreign-source dividends.

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[5] The data system in Alaska did not permit a determination of the revenue impact of the Treasury proposal at this time.

Significant revenue losses were also projected by Indiana, Iowa and Maine. By 1985 legislation, Indiana conformed to the Treasury proposal with respect to water's-edge. This legislation, however, did not change the state's practices with respect to the taxation of foreign-source dividends. In light of its current practices, the state anticipates a significant revenue loss as a result of the proposed Treasury restrictions on state taxation of foreign-source dividends. Iowa, which currently considers foreign-source dividends to be taxable income to the payee corporation, subject to allocation or apportionment, estimated an annual decrease in corporate income tax revenues of $8.5 to $10.0 million. The state of Maine, which apportions all taxable foreign-source dividends, estimated an annual revenue loss of $7.0 million.

Oklahoma projected a revenue reduction of between $2.0 and $3.0 million, while Maryland and Vermont estimated a loss of $2.0 million, respectively. Colorado estimated a decrease of $2.9 million and Utah projected a loss of $1.5 million and $4.0 million, respectively, for the fiscal years ending June 30, 1987 and 1988.

Minimal revenue impact. Eight states--Louisiana, New Jersey, New York, New Mexico, North Carolina, Oregon, South Carolina, and Tennessee--and the District of Columbia reported that the Treasury proposal would have an insignificant or minimal revenue impact. These states did not provide an estimate of the revenue loss but anticipate a minimal impact. Six of these states--New Jersey, New York, North Carolina, Oregon, South Carolina, and Tennessee--partially exclude or conditionally exempt foreign-source dividends. New Jersey and New York automatically exclude 50 percent of dividends, while Illinois, Oregon, and South Carolina automatically exclude 85 percent of such payments. Moreover, in cases where the payee corporation owns the requisite percentage of stock in the payor, such dividends are totally exempted from taxation in New Jersey, New York, North Carolina, and Tennessee.

Of the fifteen states which consider foreign-source dividends to be taxable income, subject to allocation or apportionment, thirteen provided a revenue impact.[6] Two states in this category--(Louisiana and New Mexico), and the District of Columbia projected a minimal revenue impact of the Treasury proposal.

No revenue impact. Eighteen of the 45 states and the District of Columbia which levy a corporate income tax reported that the Treasury proposal would have no revenue impact. (See Table 2.) Under Michigan's single business (value-added) tax, no revenue impact results because a subtraction from the tax base is allowed for dividends received. In sixteen other states, foreign-source dividends are exempted from taxation. Although dividends are not fully exempted from taxation in Massachusetts (dividends are exempt from taxation if the payee owns 15 percent of the payor), the state reported that its taxation of foreign-source dividends is so limited that it is believed that it would fall under the definition of "an equitable portion of dividends" as described in Section 7518, (b)(E)(iii) of the Treasury bill, and that there would consequently be no revenue impact.

The data systems in five states--Alabama, Alaska, Arkansas, Kansas, and Rhode Island--did not permit a determination of the revenue impact of the Treasury proposal at this time.

Summary of revenue impacts. Six states--California, Indiana, Iowa, Maine, Montana, and North Dakota--reported a significant impact of the Treasury proposal to restrict state taxation of foreign-source dividends. Three of the four worldwide unitary tax states which could estimate the revenue impact are included among the states reporting a substantial revenue loss. Revenue reductions--above a "minimal" level but $3 million or below--were also projected in eight other states.

The majority of the 45 states and the District of Columbia which levy a corporate income tax reported that there would be no impact or a minimal revenue loss from implementation of the Treasury proposal to restrict state taxation of foreign-source dividends. Twenty-seven states fall into this category. Overall, the majority profile of these states depicts an already limited taxation of foreign-source dividends through a liberal or total exclusion policy. The current treatment of foreign-source dividends in seventeen of these states is more limited than the "equitable portion of dividends" prescribed for taxation under the Treasury proposal.

Irrespective of the revenue impact, the states widely expressed concern over this proposed federal infringement on state taxing authority. This was done on two grounds: One, federal legislation restricting state taxing authority is inappropriate under any circumstances; the report of the Treasury Working Group on Unitary Taxation recommended against restrictive legislation. Second, state action since the issuance of the Working Group report has significantly diminished the circumstances the Treasury bill addresses.

By separate state action, a number of states have limited or entirely eliminated their taxation of foreign-source dividends. Since the 1983 MATA survey on state practices with respect to the taxation of foreign-source dividends, five states have exempted these payments from taxation. Five other states amended their laws to exclude at least a portion of these payments. West Virginia, the one state which expanded its base to tax dividends received to the extent they are included in federal taxable income, did so by conforming to the federal proposal.

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[6] The data systems in Alaska and Kansas did not permit a determination of the revenue impact of the Treasury proposal at this time.

Moreover, since the 1983 NATA survey, nine states have repealed worldwide combined reporting, eight states by statute, and one state by judicial decision. In summary, a significant number of states have modified their laws with respect to the taxation of foreign-source dividends and the use of worldwide combined reporting. In the face of the sizable number of states who have modified their laws, based on individual state needs, the propriety of federal restrictive legislation was questioned.

TABLE 1

STATE TAXATION OF FOREIGN-SOURCE DIVIDENDS
(As of July 1, 1986)

State	Tax Status of Foreign-Source Dividends	Exclusion of Dividends: Automatic	Exclusion of Dividends: Total Exclusion if Payee Ownership of Payor is at Least	Allocation or Apportionment of Taxable Dividends	Revenue Impact of Treasury Proposal to Restrict State Taxation of Foreign-Source Dividends a/ (in millions)
Alabama	P		50% b/	Allo/App	Not available
Alaska	T			Allo/App	Not available
Arizona	E				None
Arkansas	P		95%	Allo/App	Not available
California	T			Allo/App	555.0
Colorado	P	c/		Allo/App	2.9
Connecticut	E				None
Delaware	E				None
Florida	E				None
Georgia	E				None
Hawaii	E				None
Idaho	T d/			Allo/App	1.0
Illinois	P	85%	80%	Allo/App	None
Indiana	T			Allo/App	e/
Iowa	T			Allo/App	8.5 - 10.0
Kansas	T			Allo/App	Not available
Kentucky	E				None
Louisiana	T			Allo	Minimal
Maine	T			App	7.0
Maryland	P		50%	App	2.0
Massachusetts	P		15%	App	None
Michigan	f/				None
Minnesota	E g/				None
Mississippi	E				None
Missouri	E				None
Montana	T			Allo/App	10.0
Nebraska	E				None
Nevada	X				
New Hampshire	T			App	.8 - .9
New Jersey	P	50%	80%	App	Minimal
New Mexico	T			Allo/App	Minimal
New York	P	50%	50%	Allo	Minimal
North Carolina	P		50%	Allo	Minimal
North Dakota	T			Allo/App	25% of corporate collections
Ohio	E				None
Oklahoma	T			Allo	2.0 - 3.0
Oregon	P	85%		Allo/App	Minimal
Pennsylvania	E				None
Rhode Island	P		100% h/	App	Not available
South Carolina	P	85%	80%	Allo	Minimal
South Dakota	X				
Tennessee	P		80%	Allo/App	Minimal
Texas	X				
Utah	P	50% i/		App	1.5j/ - 4.0k/
Vermont	T			App	.75
Virginia	E				None
Washington	X				
West Virginia	E				None
Wisconsin	P l/		80%	App	2.0
Wyoming	X				
District of Columbia	T			Allo/App	Minimal

Legend:

E: Foreign-source dividends exempt.
P: Foreign-source dividends partially excluded or conditionally exempted.
T: Foreign-source dividends considered taxable income.
X: No corporate income tax levied.
Allo: Taxable foreign-source dividends allocated to payee's commercial domicile.
App: Taxable foreign-source dividends apportioned.
Allo/App: Some foreign-source dividends allocated; others apportioned--see text.

Footnotes:

a/ For greater detail, see Table 2.

b/ The treatment accorded dividends of affiliated companies owned 50 percent or more by payees under Section 40-18-35(14), Code of Alabama 1975, as amended, is that of a deduction from gross income.

c/ Beginning with 1986 tax years, the amount of foreign-source income, including dividends, excludible by a taxpaying corporation depends on whether the taxpayer elects the federal foreign tax deduction or the foreign tax credit. If the deduction is elected, Colorado will consider all foreign-source income, less the deduction, to be taxable income. If the credit is elected, the proportion to be excluded from Colorado taxable income is the ratio of the foreign taxes paid or accrued to 46 percent (the maximum federal corporate income tax rate) of the foreign-source income. In other words, the foreign-source income is to be excluded to the extent the foreign taxes paid by the taxpayer are less than the federal taxes it would have paid had the income been U.S. income.

d/ Foreign-source dividends, exclusive of section 78 gross-up, are taxable when either allocated or apportioned to Idaho.

e/ By 1985 legislation, Indiana conformed to the Treasury proposal with respect to worldwide unitary. This legislation, however, did not change the state's practices with respect to the taxation of foreign-source dividends. The state anticipates a significant revenue loss as a result of the proposed Treasury restrictions on state taxation of foreign-source dividends.

f/ Under Michigan's single business (value-added) tax, a subtraction from the tax base is allowed for dividends received.

g/ Minnesota Statutes 290.21, subdivision 4(e) grants a 100 percent dividends-received deduction to corporations for dividends paid by a foreign corporation from income arising from sources without the United States. A foreign corporation does not include corporations organized in Puerto Rico or a possession of the United States.

h/ Dividends received from a wholly-owned foreign subsidiary are exempt in Rhode Island. (These dividends are eligible for a 100 percent deduction.)

i/ Other exclusions may also apply in Utah. See text.

j/ Estimated Utah revenue loss for fiscal year ended June 30, 1987.

k/ Estimated Utah revenue loss for fiscal year ended June 30, 1988.

l/ Wisconsin allows a 100 percent deduction for dividends received from affiliates.

TABLE 2

ESTIMATED REVENUE IMPACT OF TREASURY PROPOSAL TO RESTRICT STATE TAXATION OF FOREIGN-SOURCE DIVIDENDS a/ b/

Revenue Loss (in millions) (14 States)

California	(T)	555.0 c/
Colorado	(P)	2.9
Idaho	(T)	1.0
Indiana	(T)	d/
Iowa	(T)	8.5 - 10.0
Maine	(T)	7.0
Maryland	(P)	2.0
Montana	(T)	10.0 c/ e/
New Hampshire	(T)	.8 - .9 f/
North Dakota	(T)	25 percent of corporate collections c/
Oklahoma	(T)	2.0 - 3.0
Utah	(P)	1.5 - 4.0 g/
Vermont	(T)	.75
Wisconsin	(P)	2.0

Minimal Revenue Impact (9 States)

District of Columbia	(T)
Louisiana	(T)
New Jersey	(P)
New Mexico	(T)
New York	(P)
North Carolina	(P)
Oregon	(P)
South Carolina	(P)
Tennessee	(P)

No Revenue Impact (18 States)

Arizona	(E)	Michigan	j/
Connecticut	(E)	Minnesota	(E)
Delaware	(E)	Mississippi	(E)
Florida	(E) h/	Missouri	(E)
Georgia	(E)	Nebraska	(E)
Hawaii	(E)	Ohio	(E)
Illinois	(P)	Pennsylvania	(E)
Kentucky	(E)	Virginia	(E)
Massachusetts	(P) i/	West Virginia	(E) k/

Legend:

(T) Foreign-source dividends considered taxable income.
(P) Foreign-source dividends partially excluded or conditionally exempted.
(E) Foreign-source dividends wholly exempt from income tax.

Footnotes:

a/ The following five states impose no corporate income tax: Nevada, South Dakota, Texas, Washington, and Wyoming.

b/ The data systems in five states (Alabama, Alaska, Arkansas, Kansas, and Rhode Island) did not permit a determination of the revenue impact of the Treasury proposal at this time.

c/ Figure reflects full revenue impact of move from worldwide combined reporting to waters-edge, as well as the revenue reduction from the Treasury proposal to restrict state taxation of foreign-source dividends.

d/ By 1985 legislation, Indiana conformed to the Treasury Proposal with respect to worldwide unitary. This legislation, however, did not change the state's practices with respect to the taxation of foreign-source dividends. The state anticipates a significant revenue loss as a result of the proposed Treasury restrictions on state taxation of foreign-source dividends.

e/ Figure reflects an estimated loss of 20 percent of Montana corporate collections.

f/ Minimum revenue loss for New Hampshire based upon 85 percent and 100 percent exclusion, respectively, of foreign-source dividends.

g/ Lower figure reflects Utah revenue loss for fiscal year ended June 30, 1987; higher figure reflects revenue loss for fiscal year ended June 30, 1988. Both figures are based upon a 100 percent exclusion of foreign-source dividends.

h/ Only Sub-Part F income remains includable in the Florida income tax base on federal Form 1120. It is the state's understanding that the Treasury proposal to exempt foreign-source dividends does not impact upon Sub-Part F income. Based upon this understanding, the Treasury proposal to exempt foreign-source dividends would not impact upon Florida revenues derived from the income tax.

i/ Although Massachusetts does not fully exempt dividends from taxation, the state reported that its taxation of foreign-source dividends is so limited that it is believed that it would fall under the definition of "an equitable portion of dividends" as described in Section 7518, (b)(E)(iii), and that there would be no revenue impact.

j/ The Michigan single business tax is a value-added tax which allows subtraction from the tax base for dividends received.

k/ For tax years beginning after July 1, 1987, the amount of dividends received, to the extent included in federal taxable income, are taxable in West Virginia.

TABLE 3

ALLOCATION AND APPORTIONMENT OF FOREIGN-SOURCE DIVIDENDS

States Allocating Taxable Foreign-Source Dividends (5 States)		
Louisiana	(T)	1/
New York	(P)	2/
North Carolina	(P)	
Oklahoma	(T)	
South Carolina	(P)	

States Apportioning Taxable Foreign-Source Dividends (9 States) 3/		
Maine	(T)	
Maryland	(P)	
Massachusetts	(P)	
New Hampshire	(T)	4/
New Jersey	(P)	
Rhode Island	(P)	
Utah	(P)	5/
Vermont	(T)	
Wisconsin	(P)	

States Allocating Some Foreign-Source Dividends and Apportioning Others (16 States) 6/		
Alabama	(P)	7/8/
Alaska	(T)	7/9/
Arkansas	(P)	7/
California	(T)	7/
Colorado	(P)	7/
Idaho	(T)	10/
Illinois	(P)	10/
Indiana	(T)	10/
Iowa	(T)	10/
Kansas	(T)	10/
Montana	(T)	10/
New Mexico	(T)	10/
North Dakota	(T)	10/
Oregon	(P)	10/11/
Tennessee	(P)	12/
District of Columbia	(T)	7/

Legend:
(P) Foreign-source dividends partially excluded or conditionally exempted.
(T) Foreign-source dividends considered taxable income.

Footnotes:

1/ Louisiana allocates dividends based on business situs and commercial domicile. In addition, there is a statute which provides in part that:

> "...dividends upon stock having a situs in Louisiana received by a corporation from another corporation which is controlled by the former, through ownership of 50 percent or more of the voting stock of the latter, shall be allocated to the state or states in which is earned the income from which the dividends are paid, such allocation to be made in proportion to the respective amounts of such income earned in each state."

In most instances, the stock does not have a situs in Louisiana and when it does, it is usually the stock of a subsidiary corporation, and the dividend would be allocated based on where the income was earned.

2/ New York allocates taxable investment income in accordance with the investment allocation percentage. An exception occurs, however, when that percentage is zero. In this case, the business allocation percentage is used.

3/ With the exception of New Hampshire and Utah, these states all use the same apportionment formula for foreign-source dividends as they use for operating income.

4/ Foreign-source dividends are apportioned by New Hampshire utilizing a special formula only for tax years which begin after June 30, 1986. (However, if the method of apportionment does not fairly represent the business organization's business activity in the state, the business organization may petition for, or the commissioner may require, modification of the apportionment factors or the employment of any other method to effect an equitable apportionment of the business organization's gross business profits.)

5/ Utah provides factor relief for the inclusion of foreign-source dividends.

6/ All fifteen of these states and the District of Columbia use the same apportionment formula for foreign-source dividends as for operating income.

7/ The state uses the "business/nonbusiness" test of the Uniform Division of Income for Tax Purposes Act to determine whether a foreign-source dividend is allocated or apportioned.

8/ Alabama considers only a narrow class of dividends to be business income, and allocates nearly all dividends.

9/ For years prior to 1985, Alaska prescribed that intercompany dividends from companies included in the combination were excludable to the extent that current year income of the payor corporation was included in the combination. After January 1, 1985, intercompany dividends from companies included in the combination are excluded from apportionable income.

10/ The state uses the "unitary/nonunitary" test of the ASARCO and Woolworth cases, or a combination of the "business/nonbusiness" and "unitary/nonunitary" tests.

11/ Oregon uses a combination of the "business/nonbusiness" test and the "unitary/nonunitary" test of the ASARCO and Woolworth cases to determine whether dividends are to be allocated or apportioned.

12/ How the dividend income relates to the principal business activity of the corporation is the test for determining whether a foreign-source dividend is allocated or apportioned. Business income is apportioned and nonbusiness income is allocated.

Attachment 2

NATIONAL ASSOCIATION
OF
TAX ADMINISTRATORS

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OFFICERS

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JAMES C. WHITE, SR. Commissioner, Alabama Department of Revenue

*Past President

September 4, 1985

Office of Tax Policy
Room 3108
U.S. Department of Treasury
Washington, D.C. 20224

Attention: Mr. George Carlson

Dear Mr. Carlson:

On August 12, the NATA Committee on Unitary Taxation, J. Thomas Johnson, Illinois Director of Revenue, Chairman, met in Chicago to discuss the Treasury Department's proposed unitary tax legislation and to prepare written comments as requested by the Treasury Department in its release of July 8. On behalf of the NATA Executive Committee and its Committee on Unitary Taxation, I am submitting these comments to you today in accordance with the extension of time the Treasury has granted organizations such as NATA for this purpose.

NATA has circulated the draft legislation to each of the state tax agencies and requested that comments be sent directly to the Treasury. The NATA comments are in addition to those which the Treasury has already received from the state tax agencies.

The NATA Executive Committee commends the Treasury for preparing draft legislation which effectively represents the Worldwide Unitary Taxation Working Group's recommendations. The following comments relate to technical changes which, in the view of the NATA Executive Committee, would clarify several matters in the draft and contribute to the legislation's acceptance by the states.

Comment One

Page 1.

The second sentence of Section 6039A (a) should be revised to eliminate the reporting of a corporation's state-by-state income tax liability and to clarify the information to be included with respect to "income subject to tax" and "the method of calculation by which the corporation computed and allocated its income subject to tax by each state." NATA suggests the elimination of the reporting of state income tax liability because the tax owed by a corporation is determined to a substantial extent by provisions (exemptions, deductions, etc.) which have no relationship to the determination of taxable income by other states.

NATA suggests the second sentence of Section 6039A (a) read as follows:

"Such return shall include (1) a reconciliation of the reporting corporation's federal taxable income to the income reported for state income tax purposes in each state in which it is liable to pay income tax,

"(2) a statement on whether each corporation includible in an affiliated group has filed on a combined report basis or as a separate entity in each state in which it is liable to pay income tax,

"(3) a statement as to how the reporting corporation has reported business income and nonbusiness income for state income tax purposes in each state in which it is liable to pay income tax, together with a reconciliation of any differences in such reporting,

"(4) a statement of the reporting corporation's apportionment factors as filed and a reconciliation with the apportionment factors that would result from its use of the Uniform Division of Income for Tax Purposes Act,

"(5) each corporation in which the reporting corporation, or any corporation owning 50 percent or more of the outstanding voting stock of the reporting corporation, owns, directly or indirectly, more than twenty percent of the combined voting power of all classes of stock entitled to vote, and

"(6) such other related information as the Secretary may by regulation prescribe."

Comment Two

Page 1.

Section 6039A (b) is not clear with respect to how many spreadsheets would be required if the common parent of two corporate chains is a foreign corporation not required to file a federal income tax return and whether the spreadsheets would include information on all includible corporations.

Comment Three

Page 2.

The technical explanation that accompanies Section 6039A (c)(1)(A) should include a comment on the authority of the Secretary "at any time to increase by regulation any dollar threshold..." The explanation should note that the authority given the Secretary is designed to facilitate adjustments (1) if the currentness of the specific thresholds is affected by economic inflation and (2) if the states find, after experience with the spreadsheet information, that a higher threshold is desirable.

Comment Four

Page 3.

Section 6039A (c)(3) defines an "includible corporation" to include "any other foreign corporation that is described in 6103(i)(4)(G)." The Treasury draft, in the aforementioned section, includes in the description of "certain foreign corporations" a corporation which "under standards established in regulations to be prescribed by the Secretary, is not subject to substantial foreign tax on its net income."

NATA understands the difficulties encountered by the Working Group in defining a tax haven corporation (a corporation which may be included in a water's edge group) and the reasons for the Treasury's use of the general term "substantial foreign tax." NATA suggests that the technical explanation give recognition to the view of the state members on the Working Group that a "tax haven" be defined as any country which either does not impose an income tax or where the income tax rate is less than 90 percent of the U.S. federal tax rate. The states are prepared to work with Treasury to develop a satisfactory solution to this problem.

Comment Five

Pages 3 and 4

Section 6039A (e)(1), Dollar Penalty for Failure to Comply, should be more specific. In place of the term "comply substantially" in the first sentence, the following language is suggested:

> "If, with respect to any taxable year, a reporting corporation fails to furnish the information required by subsection (a), on or before the due date specified in subsection (a), such corporation shall pay a penalty of $1,000."

NATA recommends that the concept of "comply substantially" should be left to the regulations, as has been done with respect to other sections of the Code. The regulations issued for Section 6038 (26 C.F.R Sec.1.6038-2(k)(3)) gives Treasury the authority to waive penalties when there is substantial compliance.

Comment Six

Page 5

Section 6103(d)(1)(A): With respect to the limitations on treaty information, NATA requests that the technical explanation of the law include a comment to the effect that the states will rely on the Treasury to negotiate treaties in a manner that will enable the states to obtain such information as is necessary to enforce their tax laws.

Comment Seven

Page 5

Section 6103(d)(1)(B)(ii): Under this provision, a state agency would not have access to a Section 6039A return if a taxpayer voluntarily files its state tax return on a worldwide unitary basis or if it is a part of a related group of corporations that does so. The comments which follow are also relevant to Sections 6103(d)(2)(B)(ii) and 6103(d)(2)(C)(ii).

NATA points out that the state members of the Working Group strongly objected to the relevant provision in the Working Group report ("Common Element J") both because of the apparent inequity in barring federal assistance to states with respect to taxpayers who voluntarily use the worldwide unitary method to lower their taxes and because the inclusion of this restriction was not considered by the Working Group, and, therefore, in view of the state members, was not in fact a common element.

NATA also points out that (1) the reference to taxpayers who are "part of a related group of corporations" is new language, not reflected in "Common Element J", and it could be construed to deny the states Section 6039A information when only one member of a large affiliated group files its return on a unitary basis, and (2) this restriction will unduly complicate the disclosure requirements the designated agency and IRS must observe.

For these reasons, NATA asks that this provision be deleted.

Comment Eight

Page 8

Section 6103(d)(4)(E)(i): The language relating to a company which fails to comply with...the legal and procedural requirements of the income tax laws of such State" is unduly broad. It is suggested that the word "the" be changed to "certain" and that the technical explanation and the regulations list the requirements contained on page 31 of the Working Group report.

Comment Nine

Page 8

Section 6103(d)(4)(E) concluding paragraph: The paragraph states that a determination by the Secretary shall be conclusive and not subject to review by any court. The phrase "not subject to review by any court" may be viewed as controversial and unduly arbitrary. NATA suggests the deletion of this language as unnecessary.

Comment Ten

Page 9

Section 6103(d)(4)(F)(v): The definition of "Worldwide Unitary Basis," among other exclusions, provides in effect that a state will not be treated as taxing on a worldwide unitary basis if it includes in the corporation income base an allocated share of the income of a foreign corporation which "is subject to State income tax in at least one state by virtue of its business activities in that state." NATA is concerned over the quoted language because, for allocation purposes, the inclusion of the income of a foreign corporation whose only business activity in the United States is in a state that did not tax corporate income would apparently classify the taxing state as a state using the worldwide unitary basis and preclude its access to spreadsheet information.

This approach conflicts with the Uniform Division of Income for Tax Purposes Act. UDITPA construes the term "taxable in another state" to refer to a corporation's business activity which is either taxable in another state or which would be taxable if the state in which the business activity occurred imposed an income tax. The National Conference of Commissioners of Uniform State Laws, in submitting UDITPA, commented that "this is desirable in order to treat the business of all states equally...."

For this reason, NATA requests that the language in question be changed to "(v) foreign corporations if (I) such corporation could be subject to state income tax in at least one state by virtue of its business activities in that state;...." and that the regulations specify that the term "could be subject to State income tax" means that a state has jurisdiction to subject the taxpayer to a net income tax, whether or not the state does so.

Comment Eleven

Definition of a "State" to include the District of Columbia: the use of the term "State" in the draft should be reviewed to assure the inclusion of the District of Columbia as a "State."

Concluding Comments

NATA views the domestic disclosure spreadsheet as an important instrument in the states' programs for the effective taxation of multijurisdictional income. Following the issuance of the Working Group report, NATA submitted to the Secretary of the Treasury the names of six state tax administrators who, together with representatives named by business, would be appointed to assist the Internal Revenue Service in developing the spreadsheet. Since the spreadsheet will ultimately by used by the state tax agencies, it is important that it respond to state processing needs. NATA reaffirms its suggestion for the appointment of this committee.

Reflecting the importance NATA attributes to the spreadsheet, the NATA Committee on Unitary Taxation has recommended that NATA fully examine the possibility of its assuming the responsibilities of the designated agency provided for in the proposed legislation.

In addition to the spreadsheet, NATA expresses support for the inclusion of a monetary minimal jurisdictional standard in P.L.86-272 and for a joint study by the Treasury, the Internal Revenue Service and the states of the Section 482 regulations and related provisions. The joint study was a common element in the Water's Edge Options Two-Six in the Working Group report, and the amendment of P.L.86-272 was an element in the State options. In addition, the proposed P.L.86-272 standard parallels NATA recommended sales and use tax jurisdictional standards which the Treasury Department has been asked to support (Letter of July 31, 1985 to Assistant Secretary of the Treasury Ronald A. Pearlman from NATA Committee Chairman and New York State Tax Commissioner Roderick G.W. Chu).

NATA also urges early action to secure the Office of Management and Budget's approval for an appropriation to implement the federal assistance described in footnote 30 of the Working Group report, namely an increase in IRS resources for the enforcement of its programs for the taxation of multinational income. In a related area of federal assistance, NATA has worked closely with IRS in implementing its training program on International Tax Issues for state tax administrators. During July and August 1985, such courses were given at five different locations throughout the country and were attended by some 125 tax administrators. NATA is now working with IRS for the continuation and expansion of this program.

NATA appreciates the opportunity to comment on the Treasury's draft legislation. It looks forward to the further discussion of these matters with the Treasury.

Sincerely,

Leon Rothenberg
Executive Secretary

LR:pb

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, WASHINGTON, DC

Mr. McNEILL. Mr. Chairman, out of respect for your time pressure, I will just take a minute or two. I am pleased to be here to testify in support of S. 1974 and S. 1113 because we think this legislation is desirable. We feel it necessary for the Congress in light of the constitutional questions that Senator Mathias and others have raised, to pass this legislation and make clear the primacy of the Federal Government in the taxation of income earned outside of the United States.

We have a primary interest in ECAT in encouraging measures that will stimulate international trade and international investment. We were very pleased, Mr. Chairman, with your earlier remark about how every little piece of Federal legislation that can assist our competitiveness is to be looked at very seriously and hopefully passed.

While this is not a momentous issue in respect to the competitiveness of our firms that do business internationally, it is one of many measures that does inhibit our competitiveness, and we would hope for that reason——

Senator CHAFEE. Are your members U.S. corporations?

Mr. McNEILL. They are U.S. corporations with very large international operations. The 60 members of ECAT have worldwide sales of $700 billion a year, and they employ over 5 million persons. So, they do business in every country in the world and in every State in the United States, and the unitary method of State taxation is of very great interest.

I am very tempted, Mr. Chairman, not to say any more and just to rest our case on the debate that just took place in respect to Montana because I think that the conversation that just occurred here is illustrative of the reason why we need this legislation to be passed in order to remove any questions as to what the Constitution intends and as to what the policy of the U.S. Congress is in respect of the taxation of foreign profits.

For Montana or any other American State to tax U.S. multinationals in a way different than Montana taxes the foreign multinationals doing business in this country, I think, makes our case that we very much need this legislation passed.

Thank you.

Senator CHAFEE. Fine. Thank you, Mr. McNeill. Mr. DuBos.

[The prepared written statement of Mr. McNeill follows:]

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE COMMITTEE ON FINANCE HEARING ON THE UNITARY METHOD OF TAXATION

Monday, September 29, 1986

I am pleased to be here today to testify in support of legislation that would impose limits on the states' use of the unitary method of taxing foreign source income. It is a method that is of distinct interest to members of the Emergency Committee for American Trade (ECAT). ECAT is an organization of the chief executive officers of 60 large U.S. companies with very extensive international business operations. Annual worldwide sales of ECAT member companies are close to $700 billion and about 5 million workers are employed.

S.1974 and S.1113 embody a very simple but important principle fundamental to the conduct of the international commerce of the United States; namely, that the individual states of the United States should not design their tax laws to impose undesirable extraterritorial tax burdens on international business activities. This principle should apply equally to U.S. or foreign based enterprises. As contemplated by the framers of our Constitution, the United States should act with one voice, the Federal voice, in matters of international commerce. While the two bills represent a step in the right direction, they should be modified to completely prohibit state taxation of any foreign source income, as determined under federal income tax sourcing rules.

The proposed legislative limitations on worldwide unitary taxation

-- which takes into account the income of all foreign affiliates of corporations doing business within a state, even though such income has no connection with the state -- will not affect the ability of the states to assess tax on U.S. source income on a unitary basis of those companies doing business solely within the United States. Further, the proposed limitations do not represent an attack upon allocation formulas currently applied by the states to those entities.

We support the limitation on the use of worldwide unitary taxation rules internationally, however, because in respect of foreign income it is an unsound rule and leads to increasingly undesirable consequences.

To be specific:

... Whatever utility and justification there is for the use of income allocation formulas applied to a single corporate entity operating within two or more of the separate states of the United States, the underlying factors that can make such a system work internally are not present internationally;

... There are no agreed-upon international standards for such a system in determining the relevant apportionment factors and their relative weight, or standards to define the businesses to be included as unitary, or the income to which such rules are to be applied;

... The economic and accounting factors of wages, assets, and income are too diverse internationally to permit accurate weighting among foreign countries. Wages, assets, turnover, and the currency used, all have some comparability when applied among and confined to the states of the United States. They do not have such comparability as applied among Botswana, the United States, Ireland, and more than 100 other countries.

ECAT has a primary interest in encouraging maximum growth of United States trade and in eliminating barriers to international investment and to the export of U.S. goods. We are concerned that if the use of worldwide unitary taxation methods with respect to international income were to spread to other nations, it would create a serious threat to international trade. Each country would develop its own weighting formulas and would use administrative procedures designed to derive all possible income from the worldwide operations of all related companies. Time has demonstrated that free trade can only exist where there is an avoidance of double taxation of the same income. The worldwide unitary taxation method fails in innumerable ways to meet this time-honored test.

In contrast to the worldwide unitary taxation method, progress has been made in securing a degree of international conformity in the taxation of foreign income. There has been widespread acceptance of the principle that tax jurisdiction is exercised only where there is actual physical presence or economic activity. There is further agreement that where transactions occur between related companies, including those that are outside the taxing jurisdiction, the rule to be uniformly applied is that all export and other inter-company transactions must be conducted at arm's length on a separate accounting basis. This is the tax basis found in our Internal Revenue Code and in the laws of Germany, Canada, Japan, France, the United Kingdom, and all of the other developed countries. It is the basis of taxation embodied in the 1977 OECD Model Income Tax Convention. It is also embodied in a Model Income Tax Convention for Treaties between Developed and Developing Countries. Those few states utilizing the worldwide unitary taxation method, which takes into account the income of corporations that are not engaged in business in the United States, are clearly out of step with United States and international practice.

We believe that the worldwide unitary taxation practice of a few American states presents an especially burdensome requirement for foreign corporations that have no independent reason to compile or maintain records conforming to U.S. tax accounting standards. The administrative burden, coupled with the demonstrated extraterritorial reach of the tax assessed, has two important practical consequences. The first is that because foreign governments resent the worldwide unitary taxation method of apportionment as an erroneous extraterritorial extension of taxing jurisdiction, they are unwilling to provide favorable tax treatment for American business operations abroad. Department of Treasury representatives have found that the worldwide unitary taxation method has been a significant adverse burden on United States foreign commerce and in international tax treaty negotiations.

Another important related factor is that the worldwide unitary taxation method is a deterrent to the type of foreign investment the United States would presumably benefit from the most; namely, manufacturing investment by foreign multinationals who today must weigh the consequences on their entire worldwide structure when making investment decisions. Their corporate structure could involve dozens or even hundreds of foreign affiliates that conduct no business in the United States. Thus, a decision to invest in the United States could, under the worldwide unitary taxation method, create the risk of the income of those affiliates being taxed by a single state of the United States. Obviously, foreign companies have some freedom of choice in avoiding states advocating such methods of taxation.

We are gratified that a number of states in recognition of this problem concerning foreign investment in their respective jurisdictions have taken steps toward elimination of the worldwide unitary taxation method. It appears that but three states -- Alaska, Montana, and North Dakota -- now use the method as compared to twelve states just a few years ago. Several states, however, still tax a portion of foreign source dividends, which amounts to a double tax on foreign income. The legislation recently passed by the state of California which will not take effect until 1988 is hardly ideal. It is deeply flawed even though it does attempt to curtail the use of the worldwide unitary method of taxation. It subjects to tax a substantial portion of foreign dividends repatriated to this country and continues to tax foreign-source operating income received by domestic corporations which operate abroad, the so-called 80/20 companies. The need for federal limiting legislation is, therefore, still needed and we urge passage of an appropriate statute.

Some state tax administrators have commented that state taxation of foreign souce income through the combined worldwide unitary taxation method will benefit the United States through discouraging foreign direct investments and thus keeping investable funds at home where they will create new businesses and jobs. While this could be a correct presumption in a specific instance, it is surely a fundamentally flawed presumption insofar as the general conduct of business is concerned.

U.S. firms invest abroad in order to service foreign market opportunities that cannot be serviced from the United States. It is just about that simple. Recognizing that there could be an exception, it is accurate to state that the U.S. market is the single largest, most important and most favored market for U.S. firms. Investable funds go first for the U.S. market and then for others.

In today's world, no U.S. industry can afford to set its sights on anything but participation in the worldwide marketplace. What is required is that they: hire worldwide; invest in a worldwide economy; manufacture worldwide; purchase worldwide; and draw on the skills and genius of scientists and engineers worldwide. In this manner, the most efficient production and lowest costs are achieved with the greatest benefit realized by consumers. In the long-term, no company or country whose strategy is to exploit business opportunities in another country can succeed without some foreign direct investment. U.S. firms could never compete in France or Germany or the U.K. today without establishing foreign subsidiaries and all they represent in the way of investment and resources. It would be unthinkable to compete in the booming Japanese market without actively engaging that market through a foreign subsidiary company.

This is the world we've come to live in -- a world in which protected national and regional markets, by definition, have become non-competitive. This is a world the economic future of which rides on the freest possible flow of international investment as well as on free flows of commerce in goods and services and ideas.

The economies of the world's industrial democracies are, therefore, without a doubt, interdependent. Whether the reason is dependence on imports or exports of raw materials, food, fuel, finished products, or technology, this interdependence is an economic fact of life. Therefore, the question that must be answered directly is whether the overseas operations of American companies are a net benefit or a net detriment to the United States. It is alleged by some that when U.S. companies conduct business abroad, the result is a loss of U.S. jobs, a loss of export markets, a deficit in our balance of payments, or a decline in our technological abilities relative to foreign countries. None of these suppositions is correct.

Rather, the choice is not between exporting or manufacturing abroad, but between being a marginal supplier in our competitors' markets or participating in those markets as a major competitor. One need only look at the great cost and complexity of research and development, the widespread technological expertise around the globe, the sophistication of customers, keen competition, and shorter periods between new product announcements to arrive at this conclusion. The only alternative would be to leave the markets to others if one decides not to or fails to participate in a global economy. In the long-term, the results would be a major contraction of business in the U.S. and rampant protectionism. It is simply impractical and illogical to attempt to maintain an internationally competitive position in major national and regional markets based upon what is essentially a short-term exploitation of export penetration. Long-term, international business success depends on true participation in worldwide markets, and that means investment.

Studies have concluded that foreign operations by U.S. companies contribute substantially to the economic strength of this country. This investment abroad by U.S. corporations has contributed to the strength of the U.S. economy in many ways.

Recent studies published by the Department of Commerce show that multinational companies -- those companies most frequently criticized on the grounds of the alleged "export of jobs" issue -- actually increased their domestic employment at a rate faster than the national average.

It is also important to note the critical importance of U.S. foreign direct investment to U.S. exports. The most recent Commerce Department survey shows that about one-third of U.S. manufactured exports are purchased by the overseas subsidiaries of U.S. firms. These foreign subsidiaries thus constitute the single largest market for U.S. exports abroad. Without such U.S. investment activities overseas, therefore, the U.S. economy would be very substantially disadvantaged.

I would also like to note that the profits repatriated to the United States from U.S. overseas direct investments far exceed foreign direct investment capital outflows from the United States. These foreign earnings are critical to the U.S. balance of payments position and to the profitability of U.S. firms and their shareholders.

As stated earlier, the reason U.S. firms establish operations abroad relates to market opportunities or marketing requirements. It is necessary, therefore, that U.S. firms maintain a market presence overseas so as to be sensitive not only to business opportunities as they occur but also to provide better service to their customers. Quality is extremely important to the continued success of any business and cannot be overemphasized. Providing reliable and defect-free products is not enough. U.S. business must also provide very responsive service to its customers if they are to attain their business objectives.

In effect, overseas investment responds to the realities of international trade. Even though progress has been made toward the goal of trade liberalization, many industries are still protected in foreign countries to the degree that overseas markets are much more difficult and expensive to serve solely through exporting.

It has been demonstrated that three-fifths of the after-tax earnings of foreign affiliates are remitted back to the U.S. parent and nearly half of this amount is retained for investment in domestic plant and equipment.

There are other benefits which are derived from such foreign investment, benefits which may be difficult to measure but are nonetheless the fruits of foreign investment. Benefits are certainly derived from the management and technical skills of other cultures and economies which result in productivity gains and advances. Not to be overlooked is the expertise received from foreign university systems. Last but certainly not least are the benefits resulting from the diversity of suppliers, competitive technologies, quality advances which provide lower costs, lower consumer prices, increased demand for products and surely increased jobs.

Let me conclude with a knowledgeable comment about the worldwide unitary taxation method made by Alan R. Short, Director of the Tax Policy Branch of the Canadian Department of Finance at Fordham University in 1976:

> "I am going to play devil's advocate, a role I enjoy, and start off with the position that I feel badly that the unitary system has had such rough treatment. Therefore, I would like to find some way to defend and support it. I would like to give it a conditional blessing with several 'ifs.' If the tax system of all countries in the world were identical, if the tax accounting practices did not differ, it everybody could agree on the principles of amalgamation, if everybody could agree as to what a unitary business is, if it was

not necessary to determine the nature or quality of the income for tax purposes (whether it was a manufacturing resource profit, an export profit, a royalty), if countries could agree on exactly the same formula for allocating income, if the price of labor and the cost of capital were idential in all countries, if we had a single monetary unit in the world, if there were no minority interests in any subsidiary companies within a group, if the existing scheme did not work, and if the unitary system was not inestimably arbitrary, I would support it."

STATEMENT OF THOMAS J. DuBOS, TAX LEGISLATIVE COUNSEL, MOBIL CORP., WASHINGTON, DC; ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. DuBos. Thank you, Mr. Chairman. My name is Thomas J. DuBos. I am employed as tax legislative counsel for Mobil Corp., and I am appearing today on behalf of the National Association of Manufacturers. I am a member of their tax committee. NAM supports S. 1974, a bill introduced by Senator Wilson on behalf of the administration and cosponsored by Senators Mathias and Hawkins.

Senator Mathias, who was a witness this morning, has long been a proponent of corrective legislation to prevent States from taxing on a worldwide combined income method and to assure proper treatment of States' taxation of dividends from income earned outside of the United States. S. 1974, the more comprehensive of the bill because Senator Mathias introduced earlier deals only with dividends, does precisely what the President's working group on unitary taxation decided.

It applies a water's edge approach to State taxation of corporate income. States would be prohibited from imposing corporate income tax on a worldwide unitary basis. The bill provides equitable taxation of dividends received by U.S. corporations from their foreign operating subsidiaries. The new legislation would allow reporting requirements for multinational corporations that will provide data that the States claim they need. The Treasury Department has indicated their intention to increase their resources devoted to the IRS's administration of tax laws applicable to the foreign operations of multinational companies.

And lastly but most importantly, competitive balance would be achieved for U.S. multinationals, foreign multinationals, and purely domestic business. Federal legislation, Mr. Chairman, is needed for the following reasons. Taxation of interstate and international commerce is a national issue. Worldwide unitary taxation by States gives rise to double taxation of foreign income.

The taxation of dividend income and 80/20 companies by a clear Federal policy is necessary to prevent the undercutting by State actions. The conduct of foreign policy is the exclusive preserve of the Federal Government. Competitive balance is needed for all taxpayers, and the severe disruption in the U.S. international economic relations can only be resolved by Federal legislation. The three principles announced by the President's working group are met by this legislation.

The President has announced his support of it in November 1985. Senator Wilson introduced the legislation in December 1985. It has been submitted and defended by Secretary Baker, Secretary Shultz, and Assistant Secretary Mentz.

The State legislation of California has serious defects. These are covered in submitted material. I regret Senator Baucus was not able to remain for the rest of the hearings. I would have enjoyed responding to some of his comments and questions. Thank you, Mr. Chairman.

Senator Chafee. Thank you, Mr. DuBos.

[The prepared written statements of Mr. DuBos and Mr. Robert A. Denman follow:]

NAM

STATEMENT OF THOMAS J. DUBOS
CHAIRMAN, STATE TAXATION OF
INTERSTATE COMMERCE SUBCOMMITTEE
NATIONAL ASSOCIATION OF MANUFACTURERS
TAXATION COMMITTEE
ON THE UNITARY METHOD OF TAXATION
BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT
SEPTEMBER 29, 1986

My name is Thomas J. DuBos. I am employed as Tax Legislative Counsel for Mobil Corporation.

I appear today on behalf of the National Association of Manufacturers. I am a member of the NAM Taxation Committee and Chairman of their Subcommittee on State Taxation of Interstate Commerce. In addition, I serve as Chairman of the Tax Committee of the National Foreign Trade Council which will file a written statement for the record and Chairman of the Coalition for the Repeal of the Unitary Tax, a voluntary coalition of ten organizations all of whom support federal legislation to resolve this issue.

NAM is a voluntary business association of over 13,500 companies, large and small, located in every state. Our members range in size from the very large to over 9,000 small manufacturing firms that each have less than 500 employees. NAM member companies employ 85% of all workers in manufacturing and produce over 80% of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council.

On behalf of our members, I am pleased to be here today to express the Association's views on the unitary method of taxation.

NAM SUPPORTS S. 1974

The NAM supports S. 1974, a bill introduced by Senator Pete Wilson on behalf of the Administration, and co-sponsored by Senators Charles Mathias and Paula Hawkins. Senator Mathias has long been a proponent of corrective legislation to prevent states from taxing on a worldwide combined income method and to assure proper treatment of states' taxation of dividends from income earned outside the United States. Indeed, his bill S. 1113 is intended to address this dividend taxation feature.

S. 1974 is a comprehensive solution that encompasses the following points:

1. The bill applies a "water's edge" approach to state taxation of corporate income. This means the determination of domestic income (that earned within the U.S.) follows the federal rules and leaves in place the separate accounting method (or "arm's length" rules) used for international purposes for apportioning income among related corporations.

2. States would be prohibited from imposing corporate income tax on a worldwide unitary basis.

3. The bill provides that equitable taxation of dividends received by U.S. corporations from their foreign operating subsidiaries be followed.

4. New federal information reporting requirements for multinational corporations will provide data available to the states to assist in the administration of their tax laws.

5. The Treasury Department intends to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. These efforts will result in benefits to the states which rely on federal information.

6. Competitive balance will be achieved for U.S. multinationals, foreign multinationals and purely domestic business.

These features comply with the three principles agreed upon by the Treasury Department's Worldwide Unitary Taxation Working Group at their final meeting on May 1, 1984.

FEDERAL LEGISLATION IS NEEDED

NAM supports federal legislation for several reasons:

1. The taxation of interstate and international commerce is a national issue.

2. Foreign governments and businesses, as well as U.S. companies, have argued that worldwide unitary taxation by states gives rise to double taxation of foreign income.

3. The taxation of dividend income and 80/20 companies by a clear federal policy is necessary to prevent an undercutting by state action. States must be limited to taxing only an equitable portion of foreign source dividends.

4. The conduct of foreign policy is the exclusive preserve of the federal government. State legislation with foreign policy implications cannot be permitted.

5. Competitive balance is needed for all taxpayers. State tax policy requirements that impose additional burdens on taxpayers solely by virtue of their foreign operations are not acceptable.

6. Serious disruption of U.S. international economic relations could occur without federal legislation.

Following the U.S. Supreme Court decision in Northwestern States Portland Cement/Stockham Values [Northwestern States Portland Cement Company v. Minnesota, 358 U.S. 450 (1959)] which focused on the narrow issue of nexus between two states, the negative reaction of the business community led the U.S.

Congress to enact Public Law 86-272 which provided stopgap jurisdictional rules and mandated a Congressional study of all state taxes based on income as they relate to interstate commerce transactions.

The 89th Congress issued its report in 1965 which demonstrated the real need for corrective legislation. A comprehensive bill (HR 11798) was opposed by business representatives and state tax administrators. A modified bill (HR 16491) became the forerunner of legislation that has been introduced in every Congress from 1965 through 1984. This subcommittee held hearings in June 1980 on the issue (S. 1688) during the 96th Congress. Nevertheless, no legislation on the subject has been enacted into law.

In June 1983 the U.S. Supreme Court ruled in the Container case [Container Corporation v. Franchise Tax Board, 103 S.Ct. 2933 (1983)] that worldwide unitary combination as applied to a domestically based group of corporations is not constitutionally prohibited. Some states then moved to enact worldwide unitary combination. Reaction by the business community and foreign governments led the Reagan Administration to convene the Worldwide Unitary Taxation Working Group, which was composed of state governors, state legislators, state tax administration organization representatives, business representatives and representatives of the White House, the State Department and the Advisory Commission on Intergovernmental Relations. The Working Group was charged with the task of producing recommendations "that will be conducive to harmonious international economic relations while also respecting the fiscal rights and privileges of the individual states."

The Working Group and its staff level Task Force held meetings over 10 months and issued a final report to President Reagan, as mentioned earlier, on May 1, 1984. Then Treasury Secretary Regan noted that "state, business and federal representatives appear to be in basic agreement on ... these principles ...

> Principle One: Water's edge unitary combination for both U.S. and foreign-based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

... State and business representatives were unable to reach agreement on the proper state tax treatment of foreign source dividends and of U.S. based corporations operating primarily abroad (so-called '80-20 corporations')."

President Reagan announced his support for federal legislation on November 8, 1985 and S. 1974 was introduced in December 1985 at the request of the Administration. The bill would generallly prohibit states from levying corporate income taxes on a worldwide unitary basis. In a March 5, 1986 letter addressed to Senator Packwood, Treasury Secretary Baker set forth an excellent presentation on the subject, including a technical explanation of the bill and a complete description of its provisions. His letter describes the serious concerns that led the Administration to propose and support this legislation.

In addition, Assistant Treasury Secretary Roger Mentz wrote on March 14, 1986 to California Assembly Republican Leader Pat Nolan, outlining the Administration's requirements for satisfactory unitary method repeal legislation. He stated therein "I am in full agreement with your view that state use of the worldwide unitary method of taxation interferes with the foreign commerical policy of the federal government." Assistant Secretary Mentz went on to point out the requirements that state legislation would need to meet to preclude the need for federal legislation.

Further, Secretary of State Goerge Shultz wrote on January 30, 1986 to the governors of states then applying the worldwide unitary method of taxation, pointing out the foreign policy arguments against the unitary method. He argued that corporate taxation on a worldwide unitary basis "creates a clear risk of double taxation" which distorts investment decisions and reduces investment flow into the U.S.

Clearly federal legislation is needed.

STATE LEGISLATION

Only three years ago there were 12 states that taxed foreign income. Within a year after the final report of the Working Group, a number of states using the worldwide unitary combination repealed their statutes. Today only three states apply the worldwide unitary method. California has just passed legislation, signed by the Governor this month, reforming the state's controversial unitary method of taxation.

There are some serious defects in the California law. This is all the more reason to enact federal legislation.

The California law does not take effect until January 1, 1988—leaving time for "backsliding" before the legislation ever comes into force.

The law allows companies to elect not to have their California tax assessment made on the worldwide unitary basis; it does not repeal the unitary method outright.

If companies elect to be taxed under the arm's length approach, they must pay a fee for the privilege. This "toll charge" raises serious questions about the constitutionality of the provision.

The state tax authorities retain powers to impose the use of worldwide unitary taxation. This discretionary privilege causes great concern to those who wish to see the worldwide combined method of taxation repealed.

The tax base will still include the income of companies that conduct 80 percent or more of their business outside the United States. Federal tax law regards such income as foreign, and yet California will continue to treat the income as subject to tax within the state.

The exclusion for dividends from subsidiaries has a limit--resulting in the taxation of dividend income received from new overseas investments made after 1986. California is continuing to reach beyond the borders of the state with respect to the taxation of foreign income.

For all these reasons, the California legislation, while perhaps a step in the right direction to rid the state of this onerous method of worldwide unitary taxation, falls short of solving the problem and meeting the principles enunciated by the Working Group.

S. 1974 is an improvement over prior versions that sought to resolve the problem, and while there are some technical changes which we believe should be made in the bill, we encourage this Subcommittee to recommend the adoption of S. 1974. Federal legislation is needed and the Congress should enact it now.

I will be pleased to answer any questions.

Thomas J. DuBos
Tax Legislative Counsel of Mobil Corporation
on behalf of
National Association of Manufacturers

NATIONAL
FARMERS
UNION

TESTIMONY

OF

ROBERT A. DENMAN
LEGISLATIVE ASSISTANT
NATIONAL FARMERS UNION

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D.C.

SEPTEMBER 29, 1986

600 Maryland Avenue, S.W. • Suite 202 • Washington, D.C. 20024 • Phone (202) 554-1600

TESTIMONY OF ROBERT A. DENMAN, LEGISLATIVE ASSISTANT FOR THE NATIONAL FARMERS UNION BEFORE THE U.S. SENATE COMMITTEE ON FINANCE, SEPTEMBER 29, 1986.

Mr. Chairman, I am Robert A. Denman, Legislative Assistant for the National Farmers Union (NFU), a family farm organization representing some 250 thousand family farms in the Nation.

The National Farmers Union has long been on record in support of the unitary method of calculating the taxable income inational corporations. We testified before the House Ways and Means Committee in 1980 in opposition to legislation similar to S. 1974 , the subject of today's hearing. In the 1982 Supreme Court case of the Container Corporation of America v. the California Franchise Tax Board, the NFU filed an Amicus Curiae brief in support of the Franchise Tax Board noting that "invalidation of the California tax would result in discriminatory treatment based solely on geographic considerations." We argued then and continue to hold that fairness to state and local taxpayers requires that those engaged in interstate and foreign commerce pay a fair share of the burdens of government.

I come before you today because we believe that should federal legislation restricting state taxation of multinational corporations be enacted, it would pose a threat to American farmers because: 1) It would subsidize foreign investment in U.S. farmland by sheltering the profits of foreign investors from effective state taxation; 2) It would encourage the restructuring of corporations so that the bulk of their American profits could be attributed on paper for tax purposes of foreign subsidiaries or associates; 3) It would result in a severe loss of revenue to State governments, tending to shift the tax burden to the real property tax base, already sorely overtaxed.

The tax climate of the U.S. is already tilted in favor of foreign investors in the U.S., and in favor of the flight of capital of the nation's corporations into foreign investment, both trends being motivated by the prospect of tax avoidance. More American farmland has come under foreign ownership since 1977 than in the past fifty years. Fifty-four percent of all farm land parcels owned or controlled by alien investors have been acquired since 1975. We are not contending that all investment by U.S. companies in foreign plants and subsidiaries or all investment by foreign companies in American plants and subsidiaries is undesirable. But, we do question such investment where its principle motivation is tax avoidance.

United States tax policy, in our view, must recognize the economic self-interest of the United States. If, due to federal legislation, the unitary method of computing taxable income were to be disallowed, this would shift a substantial annual tax load, estimated in the hundreds of millions of dollars annually, from the foreign persons and corporations to state and local taxpayers. Since state sales and income levies are already at what many regard as scarcely tolerable levels, the tendency would be for the revenue lost by the states to be sought largely from the property tax base. In many states, agricultural land is an important part of that tax base. In contrast, the tax burden imposed on the multinational corporations by the U.S. federal government and the several states is relatively light.

A decision of this body to bar the use of the unitary apportionment system would have the effect of acquiescing in discrimination in favor of multinational corporations to the detriment of domestic corporations. It would interfere with the rights of the states to tax income which is earned, in part, in their respective states and also lead, undoubtedly, to a restructuring of business activity in order to avoid state taxes.

Such a decision would encourage multinational corporations to engage in a tax "shell game", to assign their profits to jurisdictions which allow them to avoid or minimize tax liability. The opportunity to attribute U.S. corporate profits on paper to foreign subsidiaries or associates should not be encouraged by this body.

Our policy statement on this issue continues as follows, "At programs to the states, actions should not be taken which would impair the state tax bases or provide tax loopholes for multinational corporations."

Thank you Mr. Chairman for your time and consideration.

Senator CHAFEE. I would just like to address Mr. Johnson a moment. Now, in Illinois, of course you would repeal it, but you don't have it now, do you?

Mr. JOHNSON. We had it by action of a taxpayer who brought suit against the Illinois Department of Revenue because we prohibited the use of worldwide unitary method; and the taxpayer won in the Supreme Court of the State of Illinois, requiring the use of worldwide unitary. And until 1982 we used it, and then by legislation we abolished it.

Senator CHAFEE. And that is somewhat the situation Alaska is in, except Alaska hasn't taken the final——

Mr. JOHNSON. Alaska had taken the position where worldwide unitary was not permissible and they adopted that method when litigation was brought against the State of Alaska in fear of being required to use it, through court action, as I understand it.

Senator CHAFEE. Pardon?

Mr. JOHNSON. As I understand the Alaska litigation.

Senator CHAFEE. Now, one of the points you make is that the Wilson bill would limit the way in which States tax dividends paid by foreign corporations, and you are opposed to that?

Mr. JOHNSON. We are opposed to it because, well, it affects 24 States, because it restricts it to 85 percent, or 85 percent of the foreign dividends could not be taxed. It also suggests that a limitation on the States to prohibit the taxation of foreign dividends with no corresponding limitation in taxing domestic dividends would, in effect, encourage foreign investment over domestic investment. You could argue that; and there is no limitation on States to tax domestic dividends paid to a corporate taxpayer.

Senator CHAFEE. We have a foreign tax credit for domestic corporations, plus there is the 80 percent rule as far as dividends from subsidiaries. So, I am not sure——

Mr. JOHNSON. That is correct at the Federal level of taxation, but there is no limitation on the States as to how much of domestic dividends that a taxpayer receives must be excluded from state taxation and to have Federal legislation which would suggest that foreign dividends must be exempt from State taxation would in effect, in my opinion, encourage foreign investment because 85 percent of dividends received would not be taxed by the States, and yet States would not be restricted in the taxation of domestic dividends.

Senator CHAFEE. Well, let me brood over that one. Senator Wilson.

Senator WILSON. Mr. Chairman, I am curious. Mr. Johnson has referred to a lawsuit by which a taxpayer was able to compel the State to adopt the unitary method; and apparently, that has occurred in Alaska as well.

Mr. JOHNSON. Yes.

Senator WILSON. Who is behind these suits?

Mr. JOHNSON. We prohibited the use of the worldwide method in the State of Illinois until the taxpayer——

Senator WILSON. Who is that taxpayer?

Mr. JOHNSON. Caterpillar Tractor Co. brought suit against the State and ultimately won in the Illinois Supreme Court which determined that the use of the worldwide unitary method was required under Illinois law. But administratively, we had prohibited the use of it until that case was brought against us. Then, that case came down in March 1981, I believe. The legislature ultimately prohibited its use by adopting a law in 1982 providing for water's edge combination.

Senator WILSON. I am curious as to what taxpayer brought suit in Alaska to compel the use of the method. Does the staff know?

Mr. JOHNSON. In Alaska, they did not bring suit to use worldwide unitary. In Alaska, they used separate apportionment as I understand it. And there was a suit brought that separate apportionment or separate allocation did not properly attribute income for Alaska tax purposes. Thereafter, Alaska statutorily adopted worldwide unitary in response to that litigation.

Senator WILSON. Thank you, Mr. Chairman.

Senator CHAFEE. Let me just say this. One of the things that bothers me is the taxation under the unitary tax of these 80/20 corporations which are doing close to 100 percent of their business overseas, and yet many of them incorporated in the United States for trademark protection purposes.

It seems to me to make the penalty of trying to protect themselves to be that they are taxed in the United States by the States is an unfortunate result because they could have a foreign subsidiary.

Mr. JOHNSON. If I could respond to that, Senator? If in fact most of the property and payroll of those 80/20 corporations are in fact outside of the United States and not located in any of the 50 States or the 45 that tax corporate income, the income generated by those factors will be attributed outside this country. What we don't understand is why 80/20 corporations and not others—the bill does not suggest that they shouldn't be taxed by the States, but that they cannot be included in the combined unitary business report of the States. And we don't understand, especially with the fact that the Federal Government does not have as keen an interest as we would have. And the value that is being transferred between those corporations in wholly domestic operations—why they must be excluded from the water's edge combination.

I don't think there is any policy justification for it. If in fact the property and the payroll of those corporations are located outside the United States, the income generated by those factors will not be attributed to any of the 50 States.

Senator CHAFEE. Now, that is not quite true. That is what the whole thing is about here. That is the problem; that is why we are here because of those very factors you are talking about. The income indeed is taxed in the United States. It is computed. Is that not right, Mr. DuBos?

Mr. DUBOS. Mr. Chairman, you are correct. Mr. Johnson's statement would be absolutely true if this legislation were enacted and water's edge applied. The problem is that water's edge does not apply.

Senator CHAFEE. Sure.

Mr. DUBOS. The income of 80/20 companies is included within the consolidation under the California legislation. Secretary Mentz pointed out the anomaly that the proposed Federal legislation would include corporations operating under section 936 from Puerto Rico but exclude 80/20's. California does the reverse. So, Mr. Johnson's conclusion would be right if we enact the bill. I recommend we do so. [Laughter.]

Senator CHAFEE. You have 30 seconds because I have to get to a conference.

Mr. JOHNSON. I disagree, Senator. Any corporation that has any foreign factors that is included in the unitary water's edge, even if they are 50 percent United States, then the factors and the income generated by those factors will be apportioned outside of the continental United States and, therefore, will not be taxable by the States; 80/20—where that figure came from—it is not sacred. Are you saying that if a corporation has got 75 percent of its factors outside the United States and 25 percent inside the United States that he can be included in the combined report, but just because it is 80/20, they should be excluded? I don't understand the difference, and I don't think anybody else does, other than that it is an arbitrary exclusion.

Senator CHAFEE. Thank you all very much. I would like to say to all of you on a completely different subject that I am intensely interested in this competitive position. And if any of you want to send in materials to help the competitive position—minor though they might be—of U.S. corporations abroad by legislation, please do. Don't flood me, but just send it in. Make it succinct if you can. I know that ECAT is deeply involved in this. All right. Thank you very much.

[Whereupon, at 11:36 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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October 15, 1986

Sen. John H. Chafee
Committee on Finance
Subcommittee on Taxation and Debt Management
219 Dirksen Building
U.S. Senate
Washington, D.C. 20515

Dear Senator Chafee:

While I was disappointed I was unable to testify at the recent hearings on the unitary method of taxation, I understand that limited amount of time for this hearing restricted the number of witnesses who were able to testify. I appreciate, though, the opportunity to submit written testimony for the hearing record. I have attached ten copies of my testimony.

I was pleased to learn that the Administration recommended that the Senate not consider legislation restricting the states' use of the unitary tax. I remain firm in my belief that the unitary method is a fair and equitable manner of taxing corporate activity within the respective states.

If you have any questions regarding this testimony, please do not hesitate to call me.

Sincerely,

Byron

Byron L. Dorgan
Member of Congress

BLD:akl

I urge this Subcommittee to reject S. 1974 and any similar proposals to restrict state taxation of multinational corporations. S. 1974, introduced by Senator Wilson, would prohibit the states from using worldwide unitary combination; exclude certain domestic corporations from the water's edge; and severely restrict state taxation of foreign dividends. Having served as North Dakota's tax commissioner from 1969 to 1980 , I can tell you from experience that the alternative to the unitary method, the so-called "arm's length" or separate accounting method, is unworkable both in theory and practice.

It is important to underscore that the unitary method is simply an accounting device, not an additional tax, used to measure the in-state profits of a multistate or multinational corporation in a way which limits opportunities for tax avoidance. The unitary method is controversial because it is the most effective way to minimize a controversial problem: tax avoidance by multinational corporations.

As long ago as 1920, the United States Supreme Court recognized that a state is "faced with the impossibility of allocating specifically the profits earned by the processes (of a particular business) within its borders" when these activities are just a small segment of a sprawling business operation. For this reason, states have resorted to what is called "formula apportionment" to determine an individual state's share of the taxable income of a single corporation that operates across state or national borders. Under this approach, a portion of the income of a single corporation considered to be a "unitary" business is attributed or "apportioned" to the taxing state on the basis of relative levels of business activity. If, for example, 10 percent of the corporation's total unitary business activities (generally measured by payroll, property and sales) occur in a particular state, then 10 percent of the corporation's total income would be subject to that state's corporate income tax.

Most states apply the unitary method to small business and to businesses operating across state or national borders through branches. But some time ago, multinationals discovered a loophole in most states' use of the unitary method. That is, the subsidiary loophole. The multinationals figured out that by setting up a legally separate (although economically related) subsidiary in a state, they could claim they were not making profits in the state. By filing a few papers converting their branch into a subsidiary, they could dramatically reduce their state tax bills. Those states which have closed the subsidiary loophole apply the unitary apportionment concept on either the domestic or worldwide level. When used on the domestic level, companies are required to "combine" their domestic (those in the United States) subsidiaries in one tax return just as though they had never created paper subsidiaries. When applied on the worldwide level, both foreign and domestic subsidiaries are included in the combined report.

A main characteristic of the unitary apportionment concept is that it looks beyond corporate structure to economic reality. For example, imagine a corporation with a manufacturing plant in one state and several sales offices in other states. If sales and manufacturing are treated separately, the manufacturing operation could show a loss, while the sales offices show profits, or vice versa. Yet it is obvious that the two are inseparable parts of a single business.

The method is more easily understood by looking at the early tax cases which spawned the "unitary business" concept. As railroads linked the country, states maintained that, for property tax purposes, the value of a railroad operating within its borders exceeded the value of in-state ties, track and spikes, and other property considered separately. The states argued, and the courts agreed, that a more realistic measure of in-state railroad value was determined by looking to the value of the entire rail system. States, therefore, won the right to tax their proportionate shares of the total value of each railroad on the basis of the proportion of the railroad's in-state track compared to its total track in all states.

The unitary method is a natural extension of this early tax principle, brought up-to-date to deal with the increasingly complex economic world of multistate and multinational corporations.

In its landmark 1983 ruling in Container Corp. vs. California Franchise Tax Board case, the U.S. Supreme Court upheld the unitary apportionment combination method as a "proper and fair" approach to taxation of multinational corporations. In rejecting all of the arguments raised by multinational corporations, the nation's highest court outlined many of the advantages that the unitary method provides states and confirmed that its use is clearly constitutional.

The alternative accounting method, the "arm's length" or separate accounting method, closes its eyes to economic reality and allows closely related companies to claim that they do business with their affiliates on the same basis that they conduct business with totally unrelated corporations.

While the arm's length standard may have been adequate in the simplier economic times of the 1930s when it was adopted, it is not a workable idea in today's corporate world. Multistate and multinational affiliates now sell each other machinery and parts; lend each other money; and provide each other with a wide range of research, development and managerial services. The arm's length standard somewhat naively assumes that closely-related companies charge each other the same price for these goods and services as they would an unrelated business operated at "arm's length" and that, if they do, then their income is properly attributed among the states in which they operate.

The arm's length, transfer pricing approach to calculating the source of profits of multinational corporations has variously been described as "arbitrary" and as producing "unreasonable results." The General Accounting Office (GAO) characterized the system as "too often unpredictable and subjective." Treasury officials have criticized arm's length for yielding at best "rough and unproven estimate(s)" of proper income allocations and as often being "incapable of determining the division of joint profits." Most recently, Stanley Langbein, former attorney in the Office of International Tax Counsel in the Department of Treasury (1978-1980) concluded in the February 17, 1986 issue of Tax Notes that the arm's length method is unworkable both theoretically and practically; that it is not the international norm; and that unitary apportionment represents the true norm in most instances. Langbein advocated both governmental and business support for unitary apportionment as the most widely-used, most effective and most practical means of attributing income on a geographical basis.

A leading expert in taxation issues, Professor Jerome Hellerstein, notes that "separate accounting operates in a universe of pretense; as in Alice in Wonderland, it turns reality into fancy, and then pretends it's in the real world. For the essence of the separate accounting technique of dividing the income of a unitary business is to ignore the interdependence of operations ... and treat them, instead, as if they were separate, independent and non-integrated."

Not only is the arm's length method conceptually flawed, it is also inferior in practice to the formula-based unitary combination method. There is no shortage of complaints of the administrative difficulties in implementing the arm's length standard. A 1981 GAO report ("IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations") found that:

> Representatives of all groups affected by and knowlegeable about Section 482 enforcement under the arm's length standard have voiced continuous and substantive criticisms of the regulations. The criticims focus on the fact that Section 482 enforcement creates a large administrative burden and that the end result... is too often unpredictable and subjective."

Often there are no similar transactions in the outside business world to use for price comparison in an audit -- few unrelated companies supply their competitors with loans or loan guarantees, or enter into joint purchasing agreements that allow raw materials to be bought at a lower price. It is these intercorporate "transfer prices", which the arm's length relies on, that are nearly impossible to set, as an increasing body of expert opinion testifies.

Federal officials have made headlines in recent years in their investigations of several multi-million dollar transfer pricing cases. A Business Week (August 29, 1983) article quoted a top Treasury Department official as saying:

> Where importers try to use improper transfer pricing to reduce the amount of profit from a sale in the U.S. that is taxable by the U.S. -- that is the real story in the international tax are now.

The Harvard Law Review in April of 1976, noted that the "use of the arm's length standard of the current Section 482 regulations (of the Internal Revenue Code) has been accompanied by serious problems." Similarly, the Harvard Business Review referred to separate or arm's length accounting as "the bent measuring stick for foreign subsidiaries."

Geoffrey John Harley's doctoral thesis submitted to the Law School of the University of Michigan in 1980 undertook a through examination of the unitary apportionment method and the arm's length standard and concluded:

> ...the arm's length system is theoretically unsuited to the task asked of it. It is an extremely difficult standard to apply and administer. There is strong evidence that it is not very effective in meeting its goals of tax base protection. While the unitary system is not free from difficulties, many of the criticisms of it can be effectively addressed. It is submitted that unitary apportionment is superior, in terms of its theory, and can be made to be superior in terms of its application. It would better protect the tax base, be easier to administer and much less open to abuse by taxpayers. It should provide the basis for international tax harmony.

States have been not unreasonable in their approach to taxing multinational corporations. Does any Senator know of widespread "overtaxation" that resulted from unfair apportionment of corporate income between the states? For over twenty years, the House of Representatives and the Senate has considered legislation, similar to S. 1974, to prohibit the states from utilizing the worldwide unitary method. Hearings have been held and more and more rhetoric has been added to voluminous record. It is time to get the facts on the record. I suggest that we use our legislative powers to subpoena the state tax records of witnesses claiming overtaxation by the states. My hunch is that in reviewing the tax records, we will not find overtaxation.

S. 1974 would destroy the tax and fiscal integrity of the states by granting unwarranted tax preferences to larger multinational corporations, whose size and complexity permit them to successfully play the "corporate shell game" on a worldwide scale and to otherwise arrange their affairs to escape their fair share of taxes. Without equal application of the unitary method to all corporations, small in-state businesses will be put at an unfair competitive disadvantage simply because they lack the same opportunities as multinational corporations to artifically shift profits to low tax jurisdictions. I urge you to reject S. 1974 and any similar legislation.

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STATEMENT OF THE

SECTION OF TAXATION

OF THE

AMERICAN BAR ASSOCIATION

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON S.1974 (UNITARY TAXES)

October 6, 1986

This written statement is submitted on behalf of the Section of Taxation of the American Bar Association by John B. Jones, Jr., Chair of the Section. The views expressed in the statement are those of the Section and do not represent the position of the American Bar Association.

The Section wishes to thank the Senate Finance Committee for the opportunity to submit the statement and express its views on S.1974, the unitary tax bill.

S.1974, introduced by Senator Wilson of California on December 19, 1985, would add two sections to the Internal Revenue Code (1) to mandate a federal solution to the issue of the extent to which a state may take into accounting earnings of an affiliated foreign corporation in determining taxable income of a corporation engaged in business in the state, and (2) to provide for filing a domestic disclosure spreadsheet with the Internal Revenue Service by certain corporations to assist states in administering state tax laws.

Members of the Section of Taxation represent both corporate taxpayers and state tax administrations and reflect a great diversity of viewpoints in this area. The purpose of this statement is to provide a technical analysis of the bill draft and not to present these various viewpoints. Policy considerations will be discussed only in the context of an effort to promote a more complete understanding of the issues involved.

On September 5, 1986, the Governor of California signed S.B. 85, a bill that provides, among other things, (1) corporations doing business in California with an election upon payment of an additional amount to file a California franchise tax return excluding most foreign corporations, (2) a partial exclusion from taxation of dividends paid by more than 50% owned foreign subsidiaries, and (3) for the filing with the state of a domestic disclosure spreadsheet. It has been suggested that the justification for a federal law such as S.1974 is undercut by the passage of S.B. 85. However, S.B. 85 differs in many respects from S.1974, and the enactment of a federal law may still be desirable.

The first two categories of our comments below relate to the technical aspects of S.1974. The third category of comments lists the differences between S.1974 and the California legislation. The last category discusses technical concerns with the effective date and transitional rules.

I. SECTION 7518. THE DOMESTIC WATER'S EDGE LIMITATION AND TAXATION OF FOREIGN SOURCE DIVIDENDS.

S.1974 adds section 7518 to the Internal Revenue Code to provide for federally mandated domestic water's edge filing and to provide limits on state taxation of foreign source dividends.

A. Domestic Water's Edge.

1. A state may impose an income tax on a worldwide unitary basis if a taxpayer "materially fails to comply with the requirements of section 6039A...." §7518(a)(1). Presumably each state will determine whether a taxpayer has "materially" failed to comply with section 6039A, and an opportunity exists for development of differing state standards as to what constitutes material failure. Troublesome diversity exists now in interpreting P.L. 86-272. Consideration should be given to whether there should be a single procedure for determination of whether material failure to comply with section 6039A exists. It may be possible to provide for determination by the Secretary or his delegate, but the Secretary would not necessarily be well positioned to administer a federal reporting system designed to assist states in administering state apportionment schemes. In addition, it may not be appropriate for a federal administrative official to be an arbiter of whether a state tax is to be imposed. An alternative approach would be to confer review jurisdiction on the Court of Appeals for the Federal Circuit on appeals from state determinations.

2. A state may impose an income tax on a worldwide unitary basis if a taxpayer "materially fails to comply with ... the legal or procedural requirements of the income tax laws of such State." Section 7518(a)(1). Some concern has been expressed that a state may be able to avoid the spirit of section 7518(a) by imposing unreasonable legal or procedural requirements that would cause difficult compliance problems, such as by imposing reporting burdens in matters involving intercompany pricing. While it is likely that a court would look to whether the legal or procedural requirements are reasonable, the draft statutory language should expressly require failure to comply with reasonable legal or procedural requirements as a basis for imposition of worldwide combination, and should provide for the Secretary or his delegate to issue regulations specifying what legal or procedural requirements are reasonable.

A state law may provide for a water's edge election by a "qualified taxpayer," which is defined as a taxpayer meeting various conditions with respect to the retention of records and the provision of information concerning corporate and intercorporate transactions. It is not clear whether the imposition of such conditions would fall into the category of "legal or procedural" requirements or whether they would be proscribed as exceeding the requirements of section 7518.

3. A state may impose an income tax on a worldwide basis if a government of the relevant foreign country fails to provide to such state material information on certain intercompany transactions. Section 7518(a)(2). Concern has been expressed whether a taxpayer should be subject to worldwide combination if a foreign country fails to respond to

the demands of a political subdivision of the United States. It is not clear why any action by a foreign government should provide an independent grounds for worldwide combination in addition to the grounds where the taxpayer refuses to provide the requested material information. If the inclusion is designed to attack secrecy laws of a foreign country prohibiting disclosure by the taxpayer, consideration should be given to whether it is appropriate to encourage States to deal with foreign countries on such matters. It may well be preferable to delete the reference to foreign countries in the absence of a specifically identified abuse.

4. A state law may provide for an election to file on a domestic water's edge basis upon the payment of an additional fee. Proposed section 7518(a) is silent as to whether a state could impose an "election fee" upon taxpayers opting for a domestic water's edge combination. It does provide that a state may permit a taxpayer to be taxed on the basis of a worldwide combination pursuant to "an unconditional election by such taxpayer." The permissibility of the imposition of a fee in the case of a domestic water's edge election should be clarified.

5. Large "80-20" corporations may be included in the domestic water's edge group, while smaller "80-20" corporations are excluded. A $10,000,000 threshold of U.S. compensation, sales, purchases, or property distinguishes between the two. The policy question arises whether large 80-20 corporations with a sufficiently large threshold presence in the United States should be treated differently from smaller 80-20 corporations.

6. Disputes have arisen in States with domestic water's edge statutes whether the income of a U.S. corporation includes Subpart F income of a controlled foreign corporation. The taxing statute of a worldwide combination state may or may not contain a state counterpart to Subpart F. Section 7518 should contain a provision addressing the question of the extent and manner by which States may tax Subpart F income.

7. The definition of income tax in section 7518(c)(1) refers only to the "income" of the taxpayer and may well include property taxes, gross receipts taxes, and business and occupation taxes. The definition should be limited to net income taxes.

8. The Secretary is authorized to establish regulations to determine when a foreign corporation is subject to substantial foreign tax and is accordingly an includable "tax-haven" corporation. It would seem appropriate to provide more specific legislative guidance rather than to refer the dispute to an administrative decision. In particular, if a definition of tax-haven corporation is based on a foreign tax rate equal to or less than a specific percentage of the U.S. corporate tax rate, that percentage should be provided. Other problems of a technical nature, such as determination of a

foreign tax rate of a country such as Switzerland that defers a significant part of a national tax to political subdivisions may appropriately be left to administrative action.

9. The States may argue that the effect of section 7518 allows corporations to concentrate interest expense in the domestic water's edge group while providing equity financing for foreign corporations, none of whose income will be subject to U.S. taxation by the States either at the time it is earned or when it is repatriated as dividends. It should be anticipated that one or more States will seek to disallow U.S. expenses under circumstances where section 7518 prohibits worldwide combination. In April, 1986, Utah adopted a domestic water's edge statute that disallows a portion of domestic interest expense. The bill should address the issue whether such disallowance should be prohibited, limited, or authorized.

10. In defining the water's edge group, proposed section 7518(c)(2)(D) provides for inclusion of a foreign corporation if it is subject to state income tax in at least one state and if it has certain threshold amounts of payroll, sales or purchases or property in the United States. Presumably, a foreign corporation is includable if any one of these thresholds is met. Insertion of "or" before "sales" in section 7518(c)(2)(D)(ii)(a) would clarify this.

11. Section 7518(c) would include in the water's edge unitary group foreign corporations that "carry on no substantial economic activity" and are "not subject to substantial foreign tax on their net income." U.S. shareholders use foreign holding companies to hold and manage investments in foreign corporations operating outside the U.S. These operating companies usually pay substantial foreign income taxes in their home country. The holding company may pay substantial foreign taxes on dividends, and in some cases, it may pay very little or no tax on dividends because the foreign host country grants foreign tax credits or exempts dividends to avoid double taxation. In the absence of a holding company the foreign operating companies' income is included in the U.S. shareholders' apportionable base when repatriated as a dividend and any foreign taxes paid by such foreign company would be recognized for purposes of determining whether a "substantial" tax is paid. In order not to place undue emphasis on form over substance, the bill could be clarified to provide a definition of "substantial economic activity" and whether foreign taxes paid by foreign operating subsidiaries on the earnings from which dividends are paid are attributable to the holding company for purposes of determining whether it is "subject to substantial tax on its net income."

B. State Taxation of Foreign Source Dividends.

Section 7518(b) provides a compromise solution to one of the areas of disagreement between domestic multinationals and state taxing authorities over the extent to which States may tax foreign source dividends.

1. No restrictions are imposed on the ability to tax dividends by the state of "commercial or legal domicile" of the recipient. It is unclear what is meant by legal domicile. If it is intended to mean the state of incorporation, it should so provide.

2. The proposed federal compromise will cause results that seem peculiar. For example, if the facts in Appeal of Standard Oil Co. of California, Ca. S.B.E. March 2, 1983, CCH California State Tax Reporter 400-383 are unchanged, the state of California may impose a tax on dividends received by one of four corporate shareholders of the stock of Aramco, but not on the other three. The other three shareholders may be taxable on the dividends in their states of domicile. The compromise fashioned at the federal level will defer resolution of any inequities created by the compromise to state legislatures. Federal restrictions on taxation of dividends by the state of commercial or legal domicile as well as by other states will obviate the need for state legislation by promoting uniformity.

3. Section 7518(b) will probably not resolve the question of state taxation of foreign source dividends.

a. States with an "interest offset" provision such as that contained in California Rev. & Tax. Code Section 24344 prior to its amendment by S.B.85 in the 1986 legislative session will probably "offset" a like amount of otherwise deductible interest expense with foreign source dividends not subject to allocation by formula. Domestic multinational corporations having greater interest expense than the sum of dividend and interest income will have no relief from taxation of foreign source dividends. Most domestic multinationals are believed to be such net borrowers, and accordingly will have no net change in the apportionable tax base as a result of exemption from taxation of foreign source dividends.

b. States with a provision similar to California Rev.& Tax. Code Section 24425 that disallows deductions allocable to income not included in the measure of tax have an additional basis for disallowance not only of interest expense, but also of other expenses. See, e.g., Great Western Financial Corp. v. F.T.B., 4 Cal.3d 1 (applying 24425 to dividend income) and Appeal of Mission Equities Corporation, California State Board of Equalization, January 7, 1975, 1 CCH California State Tax Reporter 10-752.13 (allocation of indirect expenses).

Both the interest offset and expense to receive nontaxable income issues should be addressed in the federal legislation. Otherwise, there will be uncertainty whether section 7518(b) overrides interest offset and expense attributable to nontaxable income provisions of state law.

4. Section 7518(b) allows inclusion of an "equitable portion" of dividends. The statute should

specifically provide that the section 78 "gross-up" should not be included in the measure of dividends taken into account. *See* *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354.

5. The discussion in paragraph I.A.5., above, relates to whether Subpart F income is includable in a domestic water's edge tax base. A corollary question is whether "deemed dividends" under I.R.C. §951 are dividends from foreign subsidiaries subject to limitation on state taxation. In addition, in the absence of specific legislative guidance, it is unclear whether the term "dividend" includes gains treated as dividends under section 1248 and dividends that are resourced to the United States under section 904.

6. Section 7518(b)(2) provides an alternative definition of the equitable portion of dividends that may be taxed by States by exclusion from the income base of the portion of the dividend that effectively bears no federal income tax after application of the foreign tax credit. Two questions that have arisen that may require legislative guidance are (1) whether the computation of taxable dividends is made on an overall, separate country or "stand alone" basis, and (2) how a residual U.S. tax on dividends is to be allocated among the dividends to determine the portion that effectively bears no federal income tax. Alternatively, the legislative history could contain examples how section 7518(b)(2) operates.

7. Section 7518(b) provides "[n]o state shall require the inclusion in the income base upon which state income tax of a corporation is calculated. . .", more than an equitable portion of foreign dividends. Income base is not a defined term. There is resulting ambiguity whether state law classifying dividend income as business income subject to apportionment or as nonbusiness income assignable to a specific location is incorporated into the "income base." For example, if apportionable business income of Corporation X is $100,000, nondomiciliary state A's share is 10%, and Corporation X receives $100,000 in includable dividends, is the state base (a) $11,500, calculated as 10% of $115,000 ($100,000 business income plus 15% of $100,000 of dividends), (b) $25,000, calculated as 10% of $100,000 plus $15,000, or (c) $10,000, calculated as 10% of $100,000 business income, assuming the dividend income is nonbusiness income? Under the Uniform Division of Income for Tax Purposes Act, a nondomiciliary state would be limited to apportioned income of $10,000. Section 7518(b) further provides "[t]his subsection shall not be construed to permit state taxation of any dividend not subject to state taxation prior to enactment of this section." It is not clear whether this language would prohibit states from amending their laws subsequent to the passage of S.1974 to tax dividends in the manner permitted by S.1974 if they had taken a different approach or not done so previously.

8. In general, the tension between state tax administrators and domestic corporations over taxation of

foreign source dividends may be attributed to lack of parity between the federal income tax system and state income tax systems that are largely intended to be based on federal taxing concepts. At the federal level, foreign source income is subject to but one tax, through the operation of the foreign tax credit. States, on the other hand, do not allow a credit or deduction for foreign taxes paid. The source of dispute over taxability of foreign source dividends is the proper treatment of foreign tax payments. If a policy goal is to provide for state taxation of foreign source dividends on a basis no greater than federal taxation of foreign source dividends, section 7518(b)(1) through (3) may afford a rough approximation.

9. Transition rules are required to provide guidance on how to treat profits of foreign subsidiaries included in the worldwide combined tax base for prior years when those profits are repatriated as dividends. Existing rules provide for exclusion of such profits when repatriated as dividends. If 15% of foreign dividends will be taxable under a state law that complies with section 7518(b), should dividends be considered paid first out of previously taxed earnings and therefore eliminated, or should the dividends be treated as being paid first out of current earnings and profits and accordingly taxable? Uniform treatment by the states will require federal legislation.

II. SECTION 6039A. DOMESTIC DISCLOSURE SPREADSHEET.

1. Section 6039A represents a simplified version of the draft domestic disclosure spreadsheet legislation issued in July, 1985, largely due to the fact that section 7518 provides a uniform domestic water's edge limitation among all the States. If section 6039A were to be enacted not accompanied by section 7518 to fulfill a promise of federal assistance to States that voluntarily limit taxation of domestic corporations, then section 6039A would have to be amended to provide standards for determination whether State laws result in taxation on a worldwide combined basis.

2. Section 6039A requires a reporting corporation to report data with respect to corporations in which it, or any corporation owning 50% or more of the outstanding voting stock of the reporting corporation, owns directly or indirectly more than 20% of the combined voting power of all classes of stock entitled to vote, and which during the reporting corporation's taxable year has engaged in transactions with the reporting corporation and its includable corporations aggregating $1 million or more. Since a combined report is applicable to corporations only where more than 50% of the voting stock is owned by an affiliated corporation, if the reporting obligation is intended to be limited to includable corporations, the references should be to situations where the reporting corporation, or any corporation owning more than 50% of the voting stock of the reporting

corporation, owns more than 20% of the voting stock of another corporation that has engaged in transactions with the reporting corporation.

3. Section 6039A provides a list of specific information to be filed, then adds "and such other related information as the Secretary may by regulation prescribe." The quoted phrase may prove to be a fertile source of conflict. It would be appropriate if the legislative history contained a clear record that the information reporting requirements do not exceed those included in Annex E of the Working Group Report.

4. Section 6039A(e) provides for penalties in the case of a corporation's failure to comply substantially with the spreadsheet requirements. However, proposed section 7518(a) provides that a State may impose its tax on a worldwide unitary basis on a corporation which does not materially comply with these same requirements. Presumably, IRS's imposition of penalties and State assessment of tax on a worldwide unitary basis could occur simultaneously; however, the interaction of these sections is open to question. If a State were to assess a tax based upon noncompliance with the spreadsheet requirements, as evidenced by imposition of penalties for noncompliance, and the taxpayer subsequently properly filed a spreadsheet stopping the running of penalties, would the assessment be invalidated? This question also arises with respect to such an assessment irrespective of the assessment of penalties.

III. EFFECT OF NEW CALIFORNIA WATER'S EDGE LAW.

1. S.B. 85 requires payment of an election fee of .03 percent of the sum of 1986 property, 1986 payroll, and current year receipts by an electing corporation for the taxable year in which the election is made and for at least the next nine years. This fee can reach a substantial amount, particularly for taxpayers such as foreign banks that engage in high volume, low spread activities. No mechanism is provided in S.B. 85 for adjustment of the formula used to determine the basis of the election fee where distortions arise.

Litigation is pending over the constitutionality of combining foreign parents with U.S. subsidiaries for taxable years prior to the effective date of S.B. 85. If the courts ultimately hold that California may not include foreign parents (and foreign subsidiaries of foreign parents) in a unitary tax return, it seems likely that the election fee imposed to avoid worldwide combination will also be invalid.

2. The water's edge group in S.B. 85 includes 80-20 corporations, while such corporations are excluded in S.1974.

3. A complex mechanism in S.B. 85 seeks to provide a basic deduction of 75% of dividends from foreign corporations more than 50% owned. The deduction increases or

decreases to the extent that the relative amount of foreign payroll decreases or increases.

a. The interest offset problem discussed in I.B., above, is partially addressed by providing a general rule that the interest expense deduction will not be reduced by virtue of the foreign dividend deduction. However, interest expense incurred for purposes of foreign investments may be offset against deductible foreign dividends. No transition rules are provided, and it is not clear whether the exception applies only to new borrowings after the effective date of the bill and whether a direct tracing of borrowing to foreign investment is required to invoke the interest offset. In addition, no specific provision addresses the question whether Rev.& Tax. Code §24425, which provides for disallowance of expenses incurred to earn nontaxable income, applies to nontaxable foreign dividends.

b. The formula used to adjust the amount of nontaxable foreign dividends is tied to foreign payroll prior to 1987. As a result, no deduction will be allowed for foreign dividends paid by corporations that have no foreign payroll during this base period, and corporations with only a small foreign payroll in the base period will experience a proportionate reduction in the percentage of nontaxable foreign dividends as the relative size of foreign payroll increases.

c. The deduction is available only to dividends paid by more than 50% owned subsidiaries. It is possible to have dividends from foreign corporations that are less than 50% owned classified as apportionable business or unitary income. As a result, unitary dividend income from less than 50% owned subsidiaries will be fully included in apportionable income, while unit income from more than 50% owned subsidiaries would be subject to the 75% deduction. Neither foreign subsidiary will be included in a combined return with the corporation receiving the dividends.

IV. EFFECTIVE DATE AND TRANSITION RULES.

The bill has an effective date of taxable years beginning after December 31, 1986. Some states impose a franchise tax for the privilege of engaging in business in a franchise year measured by income of the preceding income year. The effective date reference should clarify that in such instance taxable year means income year, not privilege year.

Some states may be required to adopt legislation as a result of enactment of S.1974, as for example to address the question whether Subpart F income is includable in the apportionable base or to provide for taxation of foreign source dividends. Not all state legislatures meet annually. An effective date shortly after enactment of S.1974 may not provide states sufficient time to react.

Statement of G. Peter D'Aloia, Vice President - Taxes
Allied-Signal Inc.
To the Subcommittee on Taxation and Debt Management
Of the Senate Committee on Finance
On the Unitary Method of Taxation

Allied-Signal is a worldwide advanced technology company whose businesses are in three primary areas -- aerospace/electronics, automotive products and engineered materials. Headquartered in Morristown, New Jersey, it employs nearly 140,000 people at more than 380 U.S. and 270 foreign locations.

Allied-Signal Inc. supports legislation which (1) would end the use by states of the worldwide unitary method of taxation and (2) would assure equitable treatment in the state taxation of foreign-source dividends.

The worldwide unitary method of taxation is, by its nature, inherently unfair. The method uses labor, real estate and capital costs as factors in apportioning worldwide income. These factors, however, differ vastly from one nation to the next. All other considerations being equal, a location with lower cost factors will produce a more profitable product. Yet, under the unitary method of apportionment, it is a location with higher cost factors that receives the relatively greater share of apportioned income. Foreign currency fluctuations add further significant distortions in the measurement and apportionment of income.

A related problem exists with the state taxation of foreign-source dividends. Such taxation subjects U.S. companies to possible multiple taxation and puts them at a competitive disadvantage compared to their foreign counterparts.

We recognize that states have expressed concern that corporations might shift income abroad. However, informational requirements such as those proposed in S. 1974, together with additional support to state taxing authorities supplied by the Treasury Department, will do much to help the states determine a taxpayer's proper amount of taxable income attributable to a particular state.

We also recognize that some states have enacted, in varying degrees, unitary tax reform. Although these reforms are steps in the right direction, they fall short of abolishing the worldwide unitary method, and in some cases they require fees if a company "elects out" of the method. The states have had ample time and encouragement to abolish the worldwide unitary method, and their failure leaves the Federal Government no alternative but to act.

October 10, 1986

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARINGS ON S.1974 AND S.1113
MONDAY, SEPTEMBER 19, 1986

STATEMENT IN SUPPORT OF S.1974

ON BEHALF OF
THE AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)
LONDON, ENGLAND

SUMMARY
OF THE
STATEMENT ON BEHALF OF
THE AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)
IN SUPPORT OF S.1974

The American Chamber of Commerce (United Kingdom), headquartered in London, England, represents some 2300 American and British industrialists dedicated to the promotion of commercial relationships between the United States and the United Kingdom. It views the continued existence of the unitary tax system as one of the most deleterious threats to the continuation of that mutually beneficial trade relationship.

Unitary taxation came into being to supplement a deficiency in normal accounting methods in allocating profitability between taxing jurisdictions in which a single corporate entity operated. It has grown beyond its original justification to reach profits outside of that jurisdiction, and even beyond the continental shores of the United States. As such, it has violated the internationally-accepted concept of "separate accounting", and has resulted in double taxation of corporate profits and undue compliance burdens on both U. S. and foreign multinational companies.

British-owned enterprises have been particularly aggrieved by the unitary system, in view of the substantial Treaty benefits which were extended to U. S. firms operating in the United Kingdom. After repeated unsuccessful attempts to secure Federal intervention, Parliament extended powers to the Government in 1985 to deprive U. S. firms with substantial operations in "unitary tax" States of certain of those benefits.

Substantial progress has been made in the United States since this time, notably the recent California modification of its unitary tax laws. However, the unitary system continues to flourish, both in that State and in three other States where the system is utilized. It is necessary, therefore, for the Federal Government to take action to register its strong opposition to unitary taxation by enacting legislation prohibiting its use within the United States.

With minor modifications, we feel that S.1974 accomplishes this purpose in a fashion which is equitable both to taxpayers and to the taxing authorities of the several States. The Chamber commends S.1974 to the Subcommittee on Taxation and Debt Management, and urges its prompt adoption.

STATEMENT ON BEHALF OF
THE AMERICAN CHAMBER OF COMMERCE (UNITED KINGDOM)
IN SUPPORT OF S.1974

PART I.

INTRODUCTION

The American Chamber of Commerce (United Kingdom) is a non-profit organization founded in 1916 under the laws of the District of Columbia, and headquartered in London, England. Since its establishment some 50 years ago, it has been dedicated to the promotion and fostering of commercial relationships between the United States of America and the United Kingdom. Its membership is comprised of some 2300 companies and individual businessmen, and is divided equally between U. S. and British interests, representing virtually every U. S. multinational company with substantial business ties to the United Kingdom, as well as a sizeable majority of British industries having investments within the United States.

During the relatively short period of its existence, the Chamber has witnessed a phenomenal growth in the trading relationships and investments between the two countries which it represents. United States direct investment in the United Kingdom, estimated at $38 billion at the close of 1985, represents the largest single deposit of American capital in any foreign nation, and exports of U. S. goods to Britain are only exceeded by those to Canada, Japan and Mexico. British direct investment in the U. S. economy of $44 billion as of year-end 1985 also represents its largest overseas capital fund, and the United States constitutes its largest export market. (Cf. footnote 1)

The Chamber has long-recognized the potentially deleterious effect of the unitary tax system followed by a handful of States on our efforts to maintain a favorable climate in which transatlantic business can flourish, and has been in the forefront of international organizations seeking some reasonable limitation on the use of that

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1. Source: U. S. Department of Commerce

method of taxation. Our membership is obviously and particularly concerned with the damage which could occur to Anglo-American commercial relationships should the continuation of this iniquitous unitary tax approach lead to a breakdown of the favorable reciprocal trade agreements existing between the British and U. S. Governments which have done much to promote the substantial commercial interchange of capital and trade among industries of the two countries.

The purpose of this Statement is to first examine the background and nature of the unitary tax system, to review the progress which has been made in recent months toward limiting its application to international commerce, and to explain why, in the views of our membership, further action is required by the Senate and House of Representatives to extinguish the threat that the system continues to hold over the continuation of a healthy international commercial relationship between the United States and its major trading partners of the Free World.

PART II.

THE UNITARY TAX SYSTEM

As originally conceived, the unitary tax system represented a simplistic and ingenuous approach to the allocation of profitability among multiple taxing jurisdictions in circumstances where normal accounting methods failed to provide an equitable distribution of income. Accepted wisdom indicates that it was first employed in the railroad industry, whose operations transversed a number of State boundaries in transporting goods and people from Point X to Point Y. In such situations, it was impossible to determine with any exactitude where the profits of the railroad company arose, and thus it was decided by the conflicting taxing jurisdictions that overall operating profits of the company should be allocated to each State on the basis of the proportion of the Company's property, payroll and sales within that particular State to the total property, payroll and sales of the entire enterprise. While one could argue that there were differences in costs of land and labor as between the various States which made such an allocation inexact or even inequitable, those differences in the most part were not sufficiently significant to overcome the simplicity of the allocation system itself, particularly in the absence of a viable alternative method of profit-division.

In this classic application, it would be difficult to take serious exception to the unitary tax approach, and, had it been confined to situations where there was no other solution to allocation of profitability, there would have been no need for the Federal Government to intervene in what, essentially, would be regarded as a State solution to a State problem. Unhappily, however, as years passed, the unitary system expanded well beyond its original purpose of supplementing the deficiencies of traditional accounting methods, and became a tool by which State tax collectors could justify imposition of local taxes on profits arising outside of their own jurisdiction.

Examining the origins of the system, one would think that it had no purpose beyond dividing the profits of a single corporate enterprise among the various States in which that company operated. If, for example, a corporate shareholder owned two subsidiaries, one of which did business solely in State A, and the other exclusively in State B, the normal assumption would be that the tax assessors in State A should have no legitimate interest in the affairs of the associated company operating in State B, since that company had no functions within State A. However, fiscal affairs are rarely that straightforward. Suppose, as an illustration, that State B subsidiary manufactured widgets which were sold exclusively by State A subsidiary. Suppose further that State B subsidiary returned a handsome profit each and every year, while State A subsidiary reported an annual operating loss. And, to compound the situation, suppose that State B's franchise tax was only 2% of profits, while State A assessed its tax at the rate of 10%. One might then begin to understand why the tax collector of State A could suspect the presence of "creative accounting" within the corporate group in the two States. From such humble beginnings sprang the theory of "unitary enterprise" and thus the "unitary tax" system. Simply put, this theory propounded that, where a group of commonly-controlled companies operated through commercial interrelationships one with the other, that group might be treated as a single corporate enterprise whose overall profitability could be allocated among all of the State taxing jurisdictions in which the group members, or any one of them, did business.

The advent of this "unitary" approach by a variety of States was not popular with the businesses affected by it, who, quite justifiably pointed out that the system ignored the principle of "separate accounting" as well as overlooking the genuine commercial reasons why different affiliated companies could well have differing financial results. Nevertheless, the system was found to be legally valid by the judiciary and, thus, was necessarily tolerated, however begrudgingly, until, at some stage, it was expanded beyond the borders of the United States.

And it is this expansion beyond the "water's edge" which is the principal cause of the international trade conflict in which we find ourselves today.

There is no single reason, or even a primary one, given by the Chamber's membership, whether U. S. or British, for their strenuous exception to the application of the unitary tax system to international operations. Obviously, some of them have been subjected to State taxation where the profitability of the local operation did not justify the excise. This most frequently occurred where a British enterprise was initiated in one of the U.S. States on a "grass roots" basis, suffering start-up losses for a period of years, but nevertheless finding themselves subject to substantial local taxation simply because the corporate group of which the State enterprise was a part happened to produce an overall profit from its operations outside of the United States.

Others point out that, while it might be acceptable to assume that the costs associated with operations in one of the U. S. States could be roughly equivalent to costs incurred in operations within another of those States (an assumption essential to the justification of the unitary profit allocation approach), it is an entirely different thing to assume that costs in Afghanistan are the same as those in Alabama....for they surely are not. The result of allocating profitability on the basis of proportionate costs, they point out, is inevitably to shift the higher share of profits to jurisdictions where the costs are greatest, a result which can only be justified by the further assumption that, the greater the costs, the greater the profitability, which is obvious economic nonsense.

While acknowledging that, in a perfect world of uniform tax laws and uniform application of them, the unitary system could be a theoretically acceptable method of taxation, our membership believes that it is fundamentally incompatible with the "separate accounting" approach which has been adopted by the U. S. Federal Government as well as every other developed country in the world, and has been incorporated in the recommended model tax conventions expounded by international organizations such as the OECD and United Nationals. The two approaches-- unitary tax and separate accounting-- cannot exist concurrently in the world of international trade without a tolerance of double-taxation of profitability, a result which countless effort has been expended to avoid through the extensive networks of double taxation treaties between the United States and its major trading partners throughout the world.

There are, of course, a number of other substantial reasons put forth for restricting the use of unitary taxation with respect to international trading operations....variability in application of allocation formulae from one State to another, excessive compliance costs in restating worldwide corporate accounts to satisfy widely disparate State requirements, unpredictable and frequently self-serving State tax determinations of when particular components of an international group are includable within the "unitary enterprise" and when they are not, the real danger that the unitary system may spread beyond the boundaries of the United States to developing countries where the simplicity of approach and ease of application of the system may be of particular appeal....all of these have been expounded in detail by others appearing before this Subcommittee and will not be repeated here.

We think it sufficient to repeat the views of our American and British membership that the unitary taxation system is not an acceptable approach to the taxation of international commerce, and if not restricted in the manner proposed by the legislation under consideration, will inevitably lead to increasing conflict between the United States and those nations with which it has traditionally maintained the strongest commercial and political ties.

PART III.

THE CURRENT STATUS OF THE UNITARY TAX DISPUTE

The attention of the Chamber was first focused on the unitary tax issue during the negotiation of the new Double Taxation Agreement between the Governments of the United States and the United Kingdom in the mid-1970s, although we had been aware of the growing concern of our membership at the spread of the unitary system during the years preceding. In 1971, the United Kingdom had made substantial alterations to its Corporation Income Tax laws, adopting certain measures to relieve the double taxation of company profitability by attributing a part of the corporation taxes on those profits against the individual tax liability owed by its shareholders on dividends received. This was accomplished through a procedure called the Advance Corporation Tax, whereunder the company would be required to withhold a certain tax percentage from distributed dividends, this advance tax (ACT) being credited firstly by the shareholder against his individual tax owed on the dividend income, and again by the payor corporation against its eventual Corporation

Income Tax assessment. The United States treaty negotiators pressed their British counterparts for an extension of this ACT credit system to dividends paid by British subsidiary companies to their American shareholders, and were successful in obtaining agreement on an ACT refund for U. S. direct investors equal to 50% of the credit which would be due to a British investor in the same circumstances. Concurrently, the U. S. agreed to a package of measures of importance to the British, one of which was a Treaty prohibition [Article 9(4)] against the imposition of Federal or State unitary taxation with respect to companies or branch operations controlled by British interests.

At the time the proposed Treaty was submitted to the Senate Foreign Relations Committee for its consideration, some 16 or more States were utilizing the unitary tax system in some measure, and a considerable opposition was mounted on the State level to inclusion of the unitary prohibition in the terms of the Treaty. After considerable debate, it was finally decided that the offending Article should be "reserved", and the Treaty was ratified by the full Senate with that deletion. However, it was apparent from later events that some assurances had been given (or were perceived to have been given) to the British Government that the unitary problem would be dealt with by the Federal Government otherwise, and, on the faith of these assurances, actual or perceived, the British House of Commons accepted the amended Treaty in 1980.

Since this time, continuing British Government representations have been made to successive Federal Administrations, seeking action to place national boundaries around the extent of the unitary tax orbit. Further efforts were exerted to persuade the State of California, one of the major jurisdictions employing the system, to adopt amendments to its tax laws which would recognize the "water's edge" principal in defining a taxable economic unit. Although then-Treasury Secretary Regan had appointed a 1983 Working Party of eminent business and academic leaders to recommend a solution to the unitary problem, little progress, if any, was made at either the Federal or State level in redressing the international concern.

This matter came to a head in the Fall of 1984, when the California legislature, after a promising start, failed at the last minute to adopt a proposal which would have effectively exempted foreign-owned enterprises from the unitary tax allocation. It was not altogether surprising, therefore, that the British Parliament adopted a measure in the Finance Bill of 1985 which gave the Chancellor of the Exchequer power to introduce measures which would deprive companies having substantial interests in "unitary tax" states from receipt of the partial ACT refund afforded by the terms of the Double Taxation Agreement with the United States. It was evident to our membership that this step had been taken with the greatest reluctance by Her Majesty's Government, but was considered a necessary measure to reinforce in the minds of the Federal Administration and U. S. industry generally the importance which the United Kingdom placed on the prompt remedy of the unitary tax problem.

Since this time (March 1985), some substantial progress has been made on both the Federal and State level in dealing with the unitary issue, one of the most important of which has been the very recent passage by the State of California of a tax law revision which comes some way toward limiting the use of the worldwide combination allocation system in that State. Unhappily, however, while certainly representing a considerable improvement over present law, the California measure falls well-short of constituting a satisfactory solution to the unitary problem on several counts. Firstly, it fails to abolish the unitary approach; indeed, that remains the standard system of allocation for State tax purposes. Rather, the revision simply allows corporate taxpayers to buy their way out of the unitary tax net by agreeing to pay an annual election fee (estimated to be worth some $38 million annually to State revenue coffers), solely in exchange for the privilege of being taxed on their actual local profits rather than on an artificial allocation of worldwide revenue. Further, the California legislation discriminates against U. S. domestic companies by failing to allow exemption of certain of their foreign profits earned by U. S. subsidiaries, and continues to tax a substantial part of dividends received from foreign-incorporated affiliates. While no one is likely to maintain that the California measure does not represent a substantial improvement over the past tax regime in that State, few would take the position that the recent legislation there constitutes an acceptable death-knell to the unitary tax system, particularly in face of the fact that three States....Alaska, Montana, and North Dakota...persist in applying unitary allocation to taxpayers doing business within their borders.

It is obvious to the Chamber's membership that a Federal solution must be found to this continuing problem, and, for that reason, we now turn to a consideration of the proposed legislation now before this Subcommittee.

PART IV.

PROPOSED FEDERAL LEGISLATION

In November 1985, President Reagan announced a series of proposals aimed to satisfy the growing international concern over the continuance of the unitary allocation system by a diminishing handful of States. He promised that the Administration would intervene as "amicus curiae" in litigations challenging the rights of States to impose unitary tax on profits arising beyond the borders of the United States, he indicated that, where appropriate, international tax treaties would be amended to deal with this problem as it affected businesses of particular foreign nations, and, most importantly, he promised that legislation would be introduced which would....

> "effect a requirement that multinationals (should) be taxed by states only on income derived from the territory of the United States ("the water's edge requirement")....."

It is this legislation, S.1974, under consideration by this Subcommittee today.

In the views of our membership, this is good legislation to which we give our wholehearted support. It represents a clear expression to the world that the United States opposes the utilization of the worldwide unitary taxation system, and dissolves the deep concern of our foreign trading partners over the past apparent reluctance of the Federal Government to come to grips with what was viewed as a major impediment to the flow of international commerce between our nations. At the same time, it extends the assistance of the Federal revenue authorities to their counterparts in State tax administrations to enable them to ascertain the true taxable income of those multinational enterprises trading within their boundaries, and, by doing so, to curtail the abuses which the "unitary" allocation approach was designed to avoid.

There are, however, a small number of technical deficiencies which exist in the proposed legislation which require correction. The most important of these, in our view, is the unfortunate latitude extended to the States to reassert a unitary formula against taxpayers who have failed to supply information required to ascertain their true taxable income, or have committed some other offense against State regulations.

We feel very strongly that this preservation of "residual powers" is a retrograde provision in legislation which is intended to demonstrate the opposition of the United States to the "unitary" system. As with our criticism of the recent California unitary tax revision, we believe that the reservation here fails to put an end to the system per se, and thus leaves open the possibility for its continued use in future years. We suggest, therefore, that this "residual powers" provision should be eliminated from S.1974, and, in its stead, an allowance of the normal type of financial and/or penal sanctions be permitted where taxpayers fail to provide required information as a result of their own negligence or wrongdoing. There are other deficiencies in the legislation of lesser importance, one being the uncertainty of the language as to the rights of States to impose conditions on the right to be taxed on the basis of their true financial results, and the other being some deviation between the definition in the proposed Federal statute of the "water's edge" concept and the standard definition of that concept employed in international tax treaties, both actual and as recommended as models by international organizations. These have been commented upon in detail by other submissions to this Subcommittee, and are easily correctible, as has been suggested.

As an Anglo-American organization, we can fully understand the natural reluctance of this Subcommittee to impose limitations upon the rights of the various States to raise local revenue. We submit, however, that this is one instance where the welfare of the foreign commercial relationships of the United States is so threatened by the continued use of a internationally unacceptable method of taxation that there is little option left to the Federal Government but to exercise its Constitutional prerogative and responsibility. We believe that S.1974 is a moderate, reasonable and wholly-equitable approach to the resolution of this pervasive problem, and we commend it to this Subcommittee for your approval.

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Statement of

the

American Federation of State, County
and Municipal Employees

Submitted to

the

Committee on Finance

on the

Unitary Method of Taxation

October, 1986

in the public service

The American Federation of State, County and Municipal Employees (AFSCME) opposes S. 1974 and other attempts to restrict state taxation of multinational corporations. As a union that represents public employees, we have long been involved in issues surrounding the structure of federal, state and local taxes. In the last several years, we have advocated tax reform proposals, including the adoption of the unitary method, in a number of states and have closely monitored federal attempts to restrict state taxing authority.

AFSCME, representing over 1.1 million employees, strongly supports the use of the worldwide unitary method for apportioning corporate income. It is a fair, consistent and efficient method for determining the profits earned by multinational corporations doing business in the United States.

The real issue at hand is whether multinational corporations will become good citizens in the states that make up this great nation. Unlike individual taxpayers and small businesses who have contributed their fair share in state taxes, many multinational corporations have avoided paying taxes on the profits they earn in states through creative accounting methods that move profits earned in a state beyond the taxing authority of the state.

Worldwide unitary is a tax accounting method that prevents multinational corporations from juggling their books to reduce the state taxes they owe. It says that, if six percent of a multinational's payroll, assets and sales are in a state, then six percent of the corporation's profit should be taxed by the state.

The 1983 United States Supreme Court decision in the Container Corporation case that upheld the constitutionality of states using the worldwide method is conclusive proof that worldwide unitary is a fair and proper method for apportioning corporate income.

The Supreme Court concluded in this case :

> "that California's application of the unitary business principle to appellant and its foreign subsidiaries (the Container Corporation) was proper, and that its use of the standard three-factor formula to apportion the income of that unitary business was fair."

The alternative approach to the unitary concept for allocating corporate income is some form of arm's length or separate accounting standard. This alternative approach has been oversold by multinational corporations.

Despite multinational corporations' claim that the arm's length standard represents the internationally accepted approach, the fact remains that no such uniform arm's length standard exists. Instead, as a recent Forbes article entitled "Balance-Sheet Babel" points out:

> For years now, rulemakers have agreed that the approach to international accounting needs change. No two countries use the same method.

Multinational corporations also claim that use of the arm's length method prevents "double taxation." Nothing is further from the truth. As the Supreme Court concluded in the Container Corporation case:

> ... even if California were to adopt some version of the arm's length approach, it could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

What multinationals often fail to acknowledge is that the arm's length method is a burdensome and inconsistent method especially when it comes to determing "transfer prices." A 1981 General Accounting Office report concluded that:

> Administering the arm's length standard under current regulations is uncertain and burdensome to both the IRS and the corporate taxpayer.
> ("IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations," General Accounting Office, September, 1981)

And, at its worst, the arm's length method allows multinational corporations to manipulate their books in order to evade paying taxes. Individual taxpayers and small businesses do not have a similar luxury of shifting income to minimize their tax burden.

Restrictions on the ability of the states to fairly determine the tax liability of a multinational corporation will have one of two possible outcomes. First, the revenue losses may mean further reductions in services which benefit the poor, the elderly, our children and low-income working people. Or, states will consider tax increases to replace lost revenue and avoid service cuts. We've seen financially pressed states opt for increases in regressive sales taxes and excise taxes--both of which are more burdensome on those at the low end of the income scale. All this in order to finance a tax reduction for multinational corporations who want a tax break not available to others.

Due to their participation in the Working Group on Worldwide Unitary Taxation, state officials recommended that states consider comprehensive "water's edge" unitary combination as an alternative to worldwide unitary combination. The comprehensive water's edge unitary combination endorsed by the state members of the Working Group includes:

- A loophole-free definition of water's edge unitary, including retention of the states' right to include so-called "80/20" corporations in the water's edge. This provision would continue to minimize tax avoidance by way of the subsidiary loophole.
- Increased federal enforcement of tax laws and greater cooperation with state tax officials, including more IRS international auditors, more information from corporations in the form of "domestic disclosure spreadsheets" and IRS assistance in conducting select audits.
- Retention of the states' right to include foreign dividends in the state tax base.

Since the Working Group report was issued in 1984, the states have demonstrated their willingness to implement their recommendations. Nine of the twelve states, including California, utilizing worldwide unitary combination at the time the report was issued, have moved away from worldwide unitary combination. In most instances, some form of water's edge unitary combination was put in place. However, to date, the federal government has yet to put in place the assistance measures it promised the states in exchange for moving away from worldwide unitary combination.

Multinational corporations are apparently not satisfied with the states repealing worldwide unitary combination. They continue to press for larger tax breaks for themselves, knowing that in doing so, someone will have to pick up the tax burden they are escaping.

The Working Group's recommendations were for voluntary state action and the Working Group was unable to reach any agreement for the resolution of the issues of foreign dividends and the inclusion of "80/20" corporations in the tax base. In each of the states that has moved away from worldwide unitary, those two issues have been resolved after lengthy discussions and negotiations between elected officials and business representatives.

Multinational corporations represented in the Working Group proceedings demanded that "80/20" corporations -- U.S.-headquartered firms with 80 percent of their property and payroll overseas -- be kept out of the definition of the water's edge. (Under this definition, an "80/20" corporation could have most, or even 100 percent, of its sales in the U.S. and still be "outside" the water's edge.) State officials countered that these corporations, are by definition, U.S. entities. In their report submitted to the President, the state representatives noted that an "80/20" loophole would create "a significant opportunity for tax avoidance through corporate shellgames" and "also destroy U.S. jobs," by creating a tax incentive for firms to pack up their American plants and move them overseas.

Business representatives on the Working Group also urged either a near or total exemption of foreign dividends from state taxation. Significantly, the issue of foreign dividends and inclusion of "80/20" corporations in the water's edge is a broader question than that of worldwide unitary combination apportionment, since 27 states will have adverse revenue impacts if restrictions such as those in S. 1974 are enacted.

In the Working Group proceedings, state officials warned that exemption of foreign dividends would force down investment and job creation in the U.S., by giving preferential treatment to operations outside the borders of the country. The holiday on this portion of the profits of the nation's largest firms would discriminate against smaller companies, which would continue to pay both state and federal corporate income taxes on the full base of their profits. In their report, state officials quoted a U.S. Treasury Department official who, in 1980, said that giving a tax exemption to foreign dividends while domestic income, including dividends, is taxed would "favor foreign over United States investment."

We urge the Committee to ignore the self-serving rhetoric of multinational corporations in their attempt to dramatically lower their state taxes. Any legitimate rationale of the federal government to intervene in state tax policy was eliminated when the California Legislature and eight additional state legislatures showed good faith in implementing the water's edge recommendations.

STATEMENT OF THE
AMERICAN PETROLEUM INSTITUTE

Submitted to the

UNITED STATES SENATE COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Regarding

THE UNITARY METHOD OF TAXATION

Washington, D.C.

September 29, 1986

API STATEMENT ON FEDERAL WORLDWIDE UNITARY LEGISLATION

While several states have made recent progress in reforming their unitary tax rules, the API believes that federal legislation is still needed to curb states' use of the worldwide combined reporting method of taxation, to establish a framework for consistent treatment of income earned abroad by multinational corporations, and to prevent multiple taxation of foreign earnings. S1974, the Unitary Tax Repealer Act, with some needed modifications, provides a good beginning for this effort, and we urge the Committee to move forward with its development.

BACKGROUND

The determination of the portion of a multistate or multinational corporation's income which is attributable to a particular state, for state income tax purposes, has been the subject of much debate almost since the inception of state income taxes. In addressing this issue it is important to recognize the fundamental difference in scope of taxing powers between federal and state governments. The federal government has the power to tax the worldwide income of its citizens, individual and corporate, but has recognized the wisdom of eliminating overlapping taxation of income earned abroad by allowing the foreign tax credit. In contrast, each state has the power to tax income only to the extent it is reasonably attributable to operations within the borders of that state. Originally, the states generally determined state taxable income by means of separate accounting - the method used by the United States government and many foreign governments. Gradually, states began shifting to a formula apportionment of the total interstate business or operating net income of each corporation. Some states went further and combined the world-wide operations of all affiliated corporations for purposes of determining the income of those members doing business in the taxing state. At one time, as many as twelve states used the worldwide combined reporting method.

Under worldwide combined reporting, a state imposes tax on an apportioned share of all net income derived by the taxpayer corporation and all its affiliated unitary corporations related by more than 50% ownership, regardless of where they are incorporated or where they do business. In determining which portion of the combined corporations' income should be assigned to a particular state, most states use an equally weighted three factor formula consisting of property, payroll and sales factors. The numerator of the factor is the corporation's property, payroll, or sales in the taxing state; the denominator, the combined worldwide property, payroll, or sales. Thus, each of the factors is said to be a ratio of in-state business activity to worldwide business activity.

PROBLEM AREAS

While worldwide combined reporting has a number of negative features, four of the most serious are the tax distortion issue, factor comparability, diversity of income attribution methods, and the administrative burden.

1. The Tax Distortion Issue

The most serious problem arising under worldwide combined reporting is the distortion created by treating taxes paid to foreign jurisdictions as "income" subject to apportionment.

Many states require that all taxes based on net income, regardless of the governmental level or location to which they are paid (federal or state, foreign or domestic), be added back to the "net" income of the taxpayer in determining the total taxable income. Many foreign governments do not operate as ours does, however. They provide services left to the private sector in the United States and have national income tax rates much higher than the statutory 46 percent federal rate in the United States. In the petroleum industry, for example, it is not uncommon to find that foreign income taxes are imposed at a 70, 80 or 90 percent rate. Requiring such a company to add back those taxes to its net income base to calculate state income taxes results in extreme distortions in that taxpayer's base income. If such taxes are treated as "income" they should certainly be allocated geographically to the jurisdiction to which paid and be excluded from the apportionment base.

To give an example of how distortion can occur, California does not allow a deduction for income taxes, but does allow a deduction for excise taxes. A California corporation doing business in Country A which raises all revenue through a single 50% national income tax may derive the same after-tax net income as from operations in Country B which raises its revenue through a single national excise tax. Although the after-tax net income is the same in each country, the taxpayer would have to report twice as much income from operations in Country A as in Country B in calculating the California income tax. The gross income is not a measure of the taxpayer's income or ability to pay taxes to the taxing state. Yet, this artificial inflation of the income base is the primary mechanism by which the various states who have used the worldwide combination method increased their income tax collections. It should be noted that this example will not be rendered moot by California's recent unitary tax changes since most overseas operations of U.S.-based companies will continue to be fully taxed.

2. Factor Comparability

"Formulary apportionment" is based on the arbitrary assumption that each dollar of property, payroll and sales produces about the same amount of income in each jurisdiction in which a corporation operates. Even within a somewhat homogeneous economy such as the U.S., the approach ignores such basic factor disparities as the enormous inflation in property costs that has taken place in the past twenty years or significant payroll cost differentials in Alaska or New York City compared to the southeastern sun belt. Combining foreign affiliates with U.S. corporations compounds the potential distortion inherent in formulary apportionment because of the even wider variation in the values of the formula factors in foreign countries and the U.S.

For example, in many cases there is no reasonable comparability in payroll costs and property value and productivity generally between foreign oil-producing countries and the United States. Because of the extremely high output of wells in certain foreign countries, the payroll and property have a much greater productivity than in the United States and the costs per barrel of oil or dollar of sales are lower. Moreover, there may be substantial differences in property ownership concepts or methods of compensating employees which reduce comparability of these factors between U.S. and foreign operations. Consequently, the denominators of the factors will be understated for companies with business operations in such countries. In this way, worldwide combined reporting apportions more income to the taxing state than is actually earned in that state and results in state taxation of foreign source income.

3. Diversity of Income Attribution Methods

Worldwide combined reporting creates a substantial risk of double taxation because the unitary concept on which it is based differs from the concept used by the U.S. national government and many foreign countries.

The internationally accepted standard of taxation is based on arm's length or separate accounting principles, has been a key element of tax treaties and treaties of commerce between the United States and other countries, and is accepted by all members of the Organization for Economic Cooperation and Development.

These principles require that a subsidiary should be taxed only on the profits it actually has made, provided that these are based on dealing at "arm's length" between the subsidiary and related corporations. Departure by the states from the "arm's length" separate accounting approach in favor of the unitary tax method applied on a worldwide combination basis may result in state taxation of foreign source income of foreign corporations which is not subjected to U.S. federal income tax and which is fully taxed abroad. Unfortunately, the states which apply this method make no attempt to adjust for such overlapping taxation.

4. Administrative Burden

In addition to the problems of income and factor distortion, worldwide combined reporting is administratively complex and burdensome. These additional administrative burdens arise from requirements to determine which affiliates should be included in the combined group, adjustments of foreign accounting systems to comport with state income tax laws, and currency translation. They can be particularly burdensome in the case of a foreign-based multinational.

Under the internationally accepted arm's length system of taxation, foreign parent corporations and their non-U.S. subsidiaries have no need to develop records based on United States tax accounting principles. However, to comply with state worldwide combined reporting requirements, foreign corporations must keep two sets of books in order to convert to U.S. tax accounting principles. For a large multinational entity, data may have to be obtained from hundreds of subsidiaries operating in numerous foreign countries.

In addition, a U.S. subsidiary may not have access to the required information relating to activities of its foreign parent and related subsidiaries. In some cases, release of the information may be a violation of the laws of the country in question. If the unavailable information is necessary for factor or income determination, then the accuracy of the apportionment to the taxing state will be even more questionable. The taxpayer is penalized by being caught between two contending governments.

THE NEED FOR A FEDERAL SOLUTION

Because of possible income and factor distortion for both U.S. and foreign-based multinationals and because of the tremendous administrative burdens imposed on companies, unitary combination interferes with international trade and investment flows, frustrates foreign commerce, and prevents the government from "speaking with one voice" in regulating foreign commerce. Indeed, foreign governments have expressed concern that taxation by states of foreign source income is likely to harm relations between them and the United States. A number of them have communicated their views that worldwide combined reporting violates our treaties of friendship, commerce and navigation, and they have openly expressed support for the administration legislation, S1974. Some foreign governments have even contemplated retaliatory actions against U.S.-based corporations.

Regardless of whether recent action by some of the states alleviates any immediate threat of foreign government retaliation, the federal government has the authority to make treaties and the responsibility to provide uniform rules to prevent states from adopting tax policies that would abbrogate those treaties.

Foreign governments are not alone in voicing concern about worldwide combination. Domestic and foreign multinational corporations have been pursuing the issue of appropriate income attribution rules for the last two decades. These companies have worked with state tax administrators and legislators, challenged worldwide combined reporting in the courts, participated in the President's 1983 Worldwide Taxation Working Group and sought appropriate federal legislation. In fact, corrective legislation addressing these issues has been introduced in each of the last six Congresses. Such legislation is still needed.

In December of 1985, the Administration developed S1974 which was introduced by Sen. Wilson. This action by the Administration, plus the attention which had been focused by the Working Group, provided new impetus for the states and the business community to attempt to resolve the problem at the state level. In fact, eight of the twelve worldwide combination states modified their laws, so that by mid-1986 only four states -- California, Alaska, Montana and North Dakota -- retained worldwide combination.

Just last August, California -- a key state in the controversy -- finally enacted legislation providing that taxpayers may elect to be taxed on either the worldwide combined method or a "water's edge" basis. Some will argue that with passage of the California legislation, the Congress does not need to act in this matter. We disagree. In fact, the California legislation provides an excellent illustration of why federal legislation is still needed.

While the California legislation is a step away from worldwide combined reporting, it does not provide a totally satisfactory solution to the problem, especially in its definition of the "water's edge group," (e.g., inclusion of 80/20 companies) and in the treatment of foreign source dividends. API believes that 80/20 corporations should be treated in the same manner as foreign corporations because their business activities occur primarily overseas. The place of incorporation should not be determinative of exclusion or inclusion in a water's edge combined report. Furthermore, under the California Act, taxpayers are required to pay a substantial annual election fee for the "privilege" of being taxed on a water's edge basis. California's taxation of foreign dividends, income of 80/20 companies, and the payment of an election fee will result in a higher California tax burden for many U.S. multinationals than if they remained on worldwide combination.

Other states which have moved away from worldwide combination have adopted a variety of substitutes. Multinational corporate taxpayers are now confronted with a plethora of taxing regimes -- frequently intended to maximize the revenue to a particular state and still presenting the potential for multiple taxation of income. Enactment of properly designed Federal legislation would provide a uniform reasonable standard for treatment of income earned by corporations doing business in multiple jurisdictions and would preclude overlapping taxation. Such action would provide assurance to foreign-based multinationals considering investment in the U.S. that they would not be subjected to this treatment in the future.

We urge the Committee to exercise its responsibility in this area and to move forward with federal legislation.

SPECIFIC COMMENTS ON S.1974

All foreign source income, including foreign source dividends, should be excluded from state taxation.

A major concern of API members is with the treatment of foreign source dividends. We note that the legislation adopts the concept of "equitable taxation" of foreign source dividends. Our concern is that because of the wide disparity in views as to what would constitute "equitable taxation," the "equitable" concept may not be practical or workable. In principle, we believe that foreign source dividends, like any other foreign source income, should not be subject to any state taxation. Such dividends could be excluded directly using the federal income tax sourcing rules (Sections 861-864, I.R.C.) or by reference to the level of business activity as is done in Illinois or as recommended under Option Four (Business) in the Report of the Worldwide Unitary Taxation Working Group.

To the extent any foreign source dividends are included in the apportionable base, a prorata portion of the factors of the payor corporation attributable to such income distribution should be included in the apportionment formula applied to the total "after tax" apportionable income. This approach was recommended under Option Five (Business) of the Working Group's Report (the so-called "Detroit Formula"). See also Container Corporation of America v. Franchise Tax Board, 103 S. Ct. 2933, 2942n.5 (1983).

Inclusion of any portion of foreign source dividends without appropriate factor recognition can be defended only as a rough substitute for any attribution or disallowance of general domestic corporate expenses with respect to such foreign source income.

Treasury's recommendation is that the 85% dividend exclusion represents "equitable taxation" of foreign source dividends. The only justification for taxation of 15% foreign source dividends would be that the 15% represents a fair allocation of associated expenses attributable to the foreign source income. Accordingly, we urge that as a necessary element of "equitable taxation," further disallowance of expense of the parent corporation (such as the interest expense offset) be prohibited if 15% of dividend income is to be subject to taxation. Alternatively, we would urge that if the states are permitted to disallow or "allocate" expenses attributable to foreign source income, then taxation of foreign source dividends should be entirely prohibited. In addition, to the extent dividends are subject to tax, the state's formulary method must be adjusted to reflect the factors of the dividend's payor. In summary, if the 85% "safe harbor" treatment of foreign source dividend taxation is included, we suggest that such approach be in lieu of allocation of expenses related to foreign source income.

The same considerations which support exclusion of foreign source dividends or other foreign source income from state taxation apply regardless of where the recipient corporation is legally or commercially domiciled. Consequently, we urge deletion of that portion of Section 7518(b) which would permit the state of commercial or legal domicile to tax foreign source dividends to a greater extent than any other state.

The legislation needs to be clarified that I.R.C. Section 78 "gross-up" of dividend should not be included in the state tax base. The "gross-up" amount is merely a device used to implement the Federal foreign tax credit and is clearly not dividend income. Also, income which is deemed a dividend for purposes of Subpart F and Section 1248, as well as dividends resourced under Section 904, and those derived from an "80/20" corporation as defined under this legislation should receive equitable treatment in the same manner as other foreign source dividends.

Taxation authorized by this legislation should be confined more closely to the true "water's edge."

The provisions of Section 7518(c) would prohibit states from including in a "water's edge" group domestic corporations which have less than 20 percent of their property, payroll and sales in the U.S. The API believes sales should be eliminated from this calculation as this factor is not truly reflective of the location of a corporation's business activity. The API further believes that the location of payroll and property should be the only test because it looks to the location of a corporation's business activity to determine if it is in substance foreign (and thus excludible) or domestic and includible. We strongly oppose the additional condition in Section 7518(c)(4) which includes a test based on specified purchase and sales amounts. This provision unnecessarily restricts and discourages a company's purchases and sales within the United States and, therefore, would adversely affect the U.S. balance of trade.

The provisions of Section 7518(c) would also permit the inclusion in a "water's edge" group of foreign corporations which "carry on no substantial economic activity" and are "not subject to substantial foreign tax on their net income." API objects to certain of these provisions, and offers the following comments: (1) to include foreign corporations in a "water's edge" unitary combination is inconsistent with the primary purpose of the bill (the same safeguards and protections--I.R.C. Section 482 and similar state statutes--apply as in the case of transactions with companies in high tax countries); however, if these corporations are included, then (2) the legislation should be clarified to provide that the activities of a foreign holding company--managing the investments in and receiving dividends from foreign operating corporations--constitute "substantial economic activity;" and (3) the legislation should provide that foreign taxes paid by foreign operating corporations on earnings from which dividends are paid are to be attributed to the holding company for purposes of determining whether it is "subject to substantial foreign tax on its net income." Additionally, the legislation should be revised to exclude from the "water's edge" group those domestic corporations that make an election under I.R.C. Section 936.

The worldwide unitary method should not be used as a penalty.

The basic purpose of Section 7518 is to restrict the use of the worldwide unitary method by states. This is a sound approach, and one supported by API. However, Section 7518(a)(1) and (2) would allow the states to require the use of the worldwide method of taxation as a penalty or sanction. Using the worldwide method of taxation as a sanction in regulating a tax system is inappropriate. We therefore recommend that Section 7518(a)(1) and (2) be deleted.

The spreadsheet provisions are generally acceptable, provided that passage of spreadsheet legislation is unalterably linked to passage of comprehensive Federal worldwide unitary legislation. However, Section 6039A requires some modification.

Subject to the non-disclosure provisions of the bill, there is no objection to providing the reporting corporation's income tax liability paid to each state, the income subject to tax in each state and the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each state. However, such information should be provided only to the Internal Revenue Service for the restricted use of state taxing authorities. Consequently, we recommend deletion of all reference to "common agency." Furthermore, the requirements as set forth in Section 6039(a) and (b) to report on companies owned by affiliates should be applied only where they own more than 50 percent of the outstanding stock of the company.

STATEMENT OF THE BRITISH GOVERNMENT BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, 29 SEPTEMBER 1986, ON S.1974 AND S.1113.

1. The United Kingdom Government have long been opposed to the use of the unitary method of taxation on a worldwide basis and have consistently urged that action be taken to prevent the application of worldwide unitary taxation to British companies. A solution was first sought when the current United Kingdom/United States Double Taxation Convention was being negotiated in the 1970s; but the United States Senate attached a reservation against the provision in the draft agreement which would have prevented individual states from applying unitary taxation to United States subsidiaries of United Kingdom corporate groups. In agreeing to ratify the Double Taxation Convention without this provision the United Kingdom Government understood that the United States Administration would take steps to resolve the matter.

2. Following the decision in 1983 in the United States Supreme Court in the case of the Container Corporation of America v The California Franchise Tax Board, in which the right of a state to use the unitary method of taxation in relation to a United States parent and its foreign subsidiaries was upheld but judgement was reserved on the position of corporations with foreign parents, the United Kingdom Government again urged the United States Administration to take action to resolve the issue. In September 1983 the President established a Working Group on Worldwide Unitary Taxation "to produce recommendations that will be conducive to harmonious international relations while respecting the fiscal rights and privileges of the individual states". The United Kingdom submitted testimony to the Working Group and a copy of that Statement is attached at Annex A. The principal points were:

(a) the Government is opposed to the application of the unitary method of state taxation on a worldwide reporting basis;

(b) the worldwide unitary method of state taxation is contrary to well established international principles and practice of taxation, and imposes unreasonable tax and administrative burdens on multinational corporate groups doing business throughout the world;

(c) worldwide unitary taxation damages commercial and economic relations between the US and the UK and other countries;

(d) worldwide unitary tax imposes significant additional burdens on both the companies and their shareholders - anomalous tax liabilities (which may be considerably larger than those calculated on the internationally accepted arm's length basis) and additional compliance costs; and

(e) As long as the worldwide unitary method persists, it will be impossible to achieve the essential economic objectives of providing a consistent and coherent tax framework for international trade and investment.

3. The United Kingdom Government were not alone in objecting to worldwide unitary taxation. The European Community and the Governments of the other major OECD countries also submitted testimony for the consideration of the Working Group. In addition a number of international businesses and business organisations gave evidence to the Working Group.

4. The Working Group reported in August 1984 and recommended that the problem be resolved by individual states, guided by three principles, on the basis that multinational corporate groups be taxed by states only on income derived from the territory of the United States - the so called "water's edge requirement". As states did not universally accept these principles the President instructed the Secretary of the Treasury to draft Federal legislation to incorporate them into law.

5. The proposed unitary tax legislation was introduced into the United States Congress on 18 December 1985. In spite of certain reservations, described in a note submitted to the US Treasury on 10 February 1986 (see copy attached at Annex B), the introduction of the Bill was welcomed by the United Kingdom Government as a significant step towards resolution of the unitary tax issue and it was hoped that rapid progress could be made towards a final solution. The principal points of concern were:

(a) although taxpayers would receive a new statutory right for a corporate group to be taxed by reference to the "water's edge", states would still retain powers to disregard that new right; and

(b) the "water's edge" definition used in the Bill was incompatible with internationally accepted principles of taxation.

6. Legislation limiting the use of worldwide unitary taxation was passed into law in California in September 1986. The United Kingdom Government welcomed the legislation as a major step towards the complete withdrawal of this method of taxation, which both the Government and representatives of British industry had been seeking for some time. The United Kingdom Government however have reservations about some aspects of the Californian legislation, and continue to look for a comprehensive solution to this problem as outlined by the President in his statement of 8 November 1985. The reservations centre particularly on the requirement that companies pay an election fee and fulfil a number of other conditions in order to have their California tax computed on the "water's edge" instead of the worldwide unitary basis, and the fact that the Californian tax authorities retain powers to impose the use of worldwide unitary taxation in certain circumstances.

7. The United States Treasury have stated that following the passage of state legislation (including in California) restrictive Federal legislation is not warranted at this stage. But they acknowledge that the Californian legislation falls short in a number of respects, and that three states still apply worldwide unitary taxation. They have said that further progress is required to address the concerns they have raised and that if such progress is not forthcoming within a reasonable time frame they might wish to recommend reconsideration of Federal legislation.

8. In these circumstances, the UK Government similarly will continue to keep under review the position in California, in other states and in the US courts, in the hope that a comprehensive solution will in due course be achieved.

ANNEX A

STATEMENT OF THE GOVERNMENT OF THE UNITED KINGDOM BEFORE THE UNITED STATES TREASURY WORKING GROUP ON WORLDWIDE UNITARY TAXATION

I. INTRODUCTION

1. Almost two years ago, the United States Government advised the Supreme Court in its brief in the Chicago Bridge & Iron Co case, that "the imposition of [a state tax] on the apportioned combined worldwide business income of a unitary group of related corporations impairs federal uniformity in an area where such uniformity is essential". That explicit pronouncement of United States policy is equally appropriate for today. Indeed, since that brief was filed, the threat to international business relations posed by the worldwide unitary method of state taxation has assumed even greater magnitude. At present 11 states employ the worldwide combined reporting system, namely Florida, California, Massachusetts, Oregon, Alaska, Idaho, Colorado, Montana, New Mexico, North Dakota and Utah. Approximately 70 per cent of the direct foreign investment in the United States comes from Western Europe. Hence, the burden of the unitary worldwide combined reporting system falls particularly heavily on European based corporations.

2. It is therefore hardly surprising that the unitary tax issue has been the subject of repeated diplomatic protests from other governments since 1979. On August 1, 1983, the 10 governments of the European Community delivered a diplomatic note to the United States Government renewing their objections to the international application of the unitary tax. Similar objections were expressed by the Japanese Government on August 11, the Netherlands Government on August 17, and the Canadian Government on August 23. Earlier protests against unitary taxation by these governments have been well publicised.

3. The United Kingdom has an interest even stronger than that of other Governments since United Kingdom direct investment in the United States is greater than that of any other country. By 1982 the cumulative total of United Kingdom investment in the United States was $23.334 billion which accounted for 23% of the foreign direct investment in the United States. Any measure which inhibits investment by British business in the United States is clearly to the detriment of both countries. Her Majesty's Government believes that unitary taxation already has a damaging effect on the business relations between the two countries and that the damage will become very serious if the issue is not speedily resolved.

4. The unitary method of taxation is wholly contrary to the agreed international method of attributing the profits of multi-national enterprises between the countries in which they operate. This is the arms-length method which seeks to ensure that profits of such enterprises are allocated in such a manner that each country is able to claim tax on the profits - and no more and no less than the profits - actually earned in that country. If all countries use the same arms-length basis in determining the profits, then double taxation should be avoided through the international net-work of double taxation agreements.

5. Unitary taxation is incompatible with this internationally agreed method. It uses a formula to determine what sum shall be charged and, as practised in the States, it may include profits brought into charge elsewhere on the arms-length basis. If unitary taxation were practised worldwide and every national state could use an identical formula for determining its share of the profits of a multinational enterprise then agreement might be reached internationally on such a basis which would eliminate double taxation. It is, however, the case that over the last 40 years or more the international community has devised and refined the arms-length method for international use. It is in this context of worldwide agreement about the method of attributing profits to multinational companies that the use of a different method by some states of the United States causes a distortion which makes it internationally unacceptable.

6. It is for these reasons that Her Majesty's Government has consistently urged that action be taken to prevent the application of unitary taxation to United Kindgom businesses. It sought to do so when negotiating the current United Kingdom/United States Double Taxation Agreement: but when in 1979, the United States Senate ratified the Treaty it attached a reservation against this provision in Article 9 (4). That Article in its original form would have prevented the United States Government and the individual states from applying the unitary method to United Kingdom corporate groups which have subsidiary companies in the United States. In its final form, the Article applied only for purposes of the United States Federal tax, which does not employ the unitary method. At the time the United Kingdom, with the approval of Parliament, ratified the amended Treaty and accepted the Senate reservation against Article 9 (4), Her Majesty's Government was given to understand that the Government of the United States would use its best endeavours to eliminate the application of the unitary method of taxation on a worldwide basis. Nevertheless, since then more states have adopted the worldwide unitary approach.

7. Attempts have been made concurrently to secure a solution through the United States courts without success. Last June the United States Supreme Court ruled in Container Corporation v Franchise Tax Board, that the California worldwide unitary tax method did not violate the Foreign Commerce Clause of the United States Constitution as applied to a United States parent corporation and its foreign subsidiaries. In so holding, the Court specifically reserved the question of the constitutionality of combined apportionment with respect to state taxation of domestic corporations with foreign parents or foreign corporations with either foreign parents or foreign subsidiaries.

In Her Majesty's Government view, the Court's decision in Container Corporation was an unfortunate setback that derived, in large measure, from the confusion caused by the failure of the United States Government to reaffirm the position taken in its original brief in the Chicago Bridge case, to which we have referred. In considering whether the California tax impaired federal uniformity and the conduct of United States foreign relations, the Court observed that the federal government's failure to file an amicus brief in the Container case suggested that "the foreign policy of the United States is not seriously threatened by California's decision to apply the unitary business concept and formula apportionment ....." Hence, Her Majesty's Government believes that the outcome of the Court's sharply divided (5-3) decision could well have been different had the federal government clearly restated what all parties originally understood to be its position.

9. Moreover, the likelihood of an early resolution of the applicability of the unitary method to the foreign parent corporation case reserved by the Supreme Court is very much in doubt. Attempts are being made to have the matter heard but two courts of appeal have dismissed suits by foreign corporations against the California Franchise Tax Board on the ground that these foreign entities lack "standing" to contest the tax assessments that are nominally addressed to their domestic subsidiaries. On the other hand, as domestic corporations, the subsidiaries cannot invoke the treaty provisions that are at the heart of the claim that the unitary method impairs the conduct of foreign relations. Hence, these court rulings render rights conferred by treaties unenforceable by the very entities these provisions were negotiated to protect-companies of one treaty party engaged in this way in the territory of the other treaty party.

0. The denial of standing to raise claims under the United States Constitution will leave foreign parent companies which in fact bear the economic burden of double taxation caused by the unitary method unable to challenge the lawfulness of that burden. This may not be "taxation without representation" as it is usually understood. But it does amount to taxation without the right to be heard, in that a levy whose constitutionality is at issue cannot be challenged by a party directly affected by it. Reciprocally narrow rulings by foreign courts would weaken the ability of the United States companies to obtain judicial protection for their investments abroad.

1. In sum, the failure of both the treaty making process and federal litigation to resolve the validity of the worldwide unitary method makes it imperative that a comprehensive solution be reached as soon as practicable. It is Her Majesty's Government's view that this method is incompatible with the internationally accepted regime for taxing the profits of multinational enterprises.

II. CRITERIA FOR JUDGING A TAX SYSTEM

12. Any tax system should be judged on whether it is capable of being administered equitably, produces certainty and efficiency, and whether it is capable of simple operation. The effects of applying unitary tax on a worldwide basis are both inequitable and uncertain. Moreover it is far from simple for the companies concerned, since it requires a restatement in US terms of the income and formula factors for each component part of a group operating worldwide. These effects in turn constitute an element of tax induced inefficiency in the world economy, which will inevitably distort trade patterns and inhibit business decisions.

Application to differing economic circumstances

3. These adverse effects can be traced to particular aspects of applying the unitary basis to the conditions and circumstances which exist today. First, when applied on a worldwide basis, the unitary system is of necessity operating in economic conditions which are far from homogeneous. The system works by combining the income of several related corporations engaged in a "unitary" business. Income is then allocated to the taxing state by multiplying the total income of the enterprise by a percentage comprised of the average of the ratios of instate property, payroll and sales to total property, payroll and sales. The precise formula varies from one State to another.

14. The theory underlying this "unitary" approach is that a dollar of payroll or property spent or a dollar of sales made in one tax jurisdiction produces roughly the same amount of taxable income as a dollar so spent or sales made in another tax jurisdiction. This theo manifestly falls down when applied to two (or more) countries whose economic circumstances are very different. For example, in a develop country property and payroll costs may be very low, relative to those in the United States. On the other hand profits will probably be hig to reflect the risks of expropriation, currency exchange limitations, or other factors. Applying the unitary basis to a group operating both in the USA and a developing country will thus result in a reallocation of group's income from the developing country to the USA Quite apart from the implications for the group itself (which are discussed in more detail below), it must be open to question whether this represents an equitable division of world resources.

Incompatibility with arm's length basis

15. Second, because international trade relations operate on an entirely different (ie arm's length) basis, the worldwide application of the unitary system produces results which are at best anomalous and at worst give rise to serious inequities. In sharp contrast to the unit method (see above), the arm's length method requires the income of ea corporation to be computed on a separate accounting basis under the assumption that each member of a corporate group must deal with the o members as if they were wholly separate entities owned by unrelated interests. This method has now been recommended by both the OECD and UN model treaty and enshrined in a worldwide network of bilateral treaties to prevent double taxation, including those treaties to which the USA is a party. In addition, following the lead given by the US Federal Authorities in 1929, virtually all developed countries have now adopted the arm's length standard for preventing tax avoidance through artificially fixed inter-company prices.

16. The unitary method and the arm's length method are not compatible. Applying the unitary formula to groups which also operate in countrie which work on the arm's length basis leads to cases of double taxatio It has been argued that the unitary basis does not in fact tax the foreign source income of foreign corporations related to the "unitary company. Instead that income is merely taken into account in order to determine the net income attributable to activity within the "unitary" state. But the arithmetical results of applying a unitary formula belie this argument. The "unitary" state is in effect requir a consolidated income tax return and subjecting to tax the income ear by foreign members of the unitary group without giving any relief for overseas tax. In other words it has extended its jurisdiction to bri into its tax net income over which other states will have exercised their priority taxing rights under the normal arm's length arrangemen

17. The element of double counting this involves can and does lead to multinational groups being taxed on more than 100 per cent of their income. This may represent an additional financial cost for the grou itself, which is inequitable. Or it could lead to a diminution of the revenues flowing to any exchequer which seeks to avoid double taxation by giving credit for the "unitary" tax paid - a result which at best can be described as anomalous. These inequities and anomalie are particularly acute in the -not uncommon case- where the US compan of a unitary group operates at a loss. Even though it had made no profit by any normal commercial standards, the US company would be liable for tax in respect of a proportion of the worldwide profits of its foreign affiliates. In other words there would be an element of direct subsidy from the worldwide group (or foreign revenue as the case may be) to the unitary state.

Unitary basis is not uniform

8. Third the unitary basis is not - and cannot be - uniform in its application. The very concepts it uses are incapable of precise definition, at least on anything other than a very local basis. It is notable that, even amongst the various states within the USA, there are significant variations first in the criteria used for determining whether or not a particular corporation is "unitary", and second in the formula to be applied to unitary corporations. Even within an individual state it is by no means unknown for a business which has been deemed "unitary" one year to be classed as non-unitary the following year, and for the basis of calculating its tax liability to vary from one year to the next. As a result no business can be sure whether or not it will be adjudged to be "unitary" and if so, how its tax bill will be calculated. In other words the unitary basis breeds uncertainty. The problem this creates for business is heightened by the lack of any procedure analogous to that embodied in "arm's length" tax treaties for resolving disputes about the application of the rules to individual cases.

Unitary basis imposes high compliance costs

19. The fourth aspect of the unitary basis which contributes towards its damaging effects is the compliance costs it involves. It is for the companies themselves to tell the Working Group what complying with the unitary system means in practice. The UK Government would merely note that the full requirements of the system necessitate, at a minimum, the translation into US dollars of accounts maintained by related companies in a multitude of different currencies and the preparation of extra sets of accounts to meet the specific, and varying, requirements of the unitary states. And we understand that the details requested often reflect confidential data, trade secrets, or other information that cannot be made available for reasons totally unrelated to tax considerations.

20. Of more direct concern to the UK Government is the extent to which the unitary states' demands for financial information may involve investigation of the records of UK companies which are outside the USA. More often than not, the substantial majority of the records required describe business transactions that are entirely unrelated to activities within the United States. This is objectionable in principle, as well as producing excessive compliance burdens in practice.

Comparison of unitary method with arm's length method

21. By contrast, the arm's length method, though not perfect, avoids these four very real problems which inevitably arise when the unitary basis is applied worldwide. First by focussing on the amount of profit that would have been made within an individual country by independent parties dealing at arm's length, it recognises that companies operating in different economic circumstances will incur different costs and run very different risks. Second, there is of course no question of the basis being incompatible with internationally -accepted methods - the arm's length basis is the international accepted method. Equally, the 'international' nature of the arm's length method helps to avoid the third problem - the lack of any uniform rules. Because it has been for so long the guiding principle of international tax, there has been time to smooth out the 'rough edges' of the arm's-length method. The countries of the world have evolved a series of internationally accepted standards which are capable of exact definition under closely applied procedures. So the various problems identified earlier - of double taxation: of companies being liable to tax on more than 100 per cent of their income, of companies bein liable to tax in respect of profits when, on normal commercial principles, they are making a loss - simply do not arise or where they do, they can be satisfactorily resolved.

22. The fourth problem, that of high compliance costs for companies, equally does not arise to anywhere near the same extent under the arm's length method. The information required in order to operate this method is, more often than not, information which companies have already had to prepare for other purposes. The use of accounts drawn up to comply with company law requirements is a good example of this.

23. Generally, therefore, when measured against the criteria for judgin a tax basis the arm's length basis is on each count preferable to th worldwide unitary method. It is at once more equitable, more certai simpler and more conducive to efficiency. Nor does there seem any good reason why it should not serve as an effective policing mechani to protect the revenue of individual states. There is an extensive of Treasury Regulations under Section 482 of the Internal Revenue C of 1954 providing definitive guidelines governing the fiscal relati ships of commonly-controlled corporations. Moreover we understand that, under long-standing accords, information gathered by the Unite States Treasury from Federal tax audits is continually made availab to the individual States. Against this background, the majority of States have felt able to operate an arm's length system, and to apply this rule to subsidiaries of multinational group resident wit their jurisdictions.

Wider consequences of the unitary system

24. Any set of rules which fails to measure up to the criteria of a go tax system must be expected to have adverse consequences which go w beyond the immediate impact of that set of rules itself. This is certainly the case with the current application, by several US Stat of the unitary system on a worldwide basis.

25. First there is now evidence that it is inhibiting trade relations a distorting investment patterns. In the light of the inequities, anomalies and uncertainties generated by the tax rules, foreign corporations are re-appraising the benefits and burdens of conducti business within a unitary state. The recent decision by the Londo Chamber of Commerce to cancel its mission to Florida on account of Florida's adoption of the worldwide unitary basis is a good example of this.

26. Furthermore, the spread of unitary taxation amongst the various Sta can only serve to undermine the very strong position that the Unite States has adopted in OECD and elsewhere for the liberalisation of international investment flows. The position was restated only a f weeks ago by President Reagan himself in his 9 September Statement US policy towards international investment. The continued impositi of unitary taxation is incompatible with this stance.

27. These adverse consequences for worldwide trade and investment woul be even worse if other countries respond to the States' applicatio unitary tax by taking retaliatory measures or introducing unitary systems of their own. In particular the States' operation of the worldwide unitary basis, and the US Federal Government's failure t prohibit this system, may well serve as an example which other cou

will soon choose to follow. In particular some developing countries may feel that the system has its attractions for them. If such countries adopt unitary tax, they would be unlikely to follow the three factor formula used, for example, in California. The very different economic conditions which prevail in the develping world would naturally incline them to develop or emphasise factors which allocate a greater proportion of income to the developing country. They might for example focus simply on sales.

28. The effects of other countries taking retaliatory measures, or unitary tax spreading outside the United States, will be keenly felt by the United Kingdom. This is because the UK invests on a substantial scale in foreign countries in both the developed and developing world. But if the UK is a substantial investor in foreign countries, the United States is a much larger one. So the adverse impact on the United States must be expected to be much greater. As things stand at present the economic burden this imposes will, in large part, fall on the United States Federal Government. Because the United State's Internal Revenue Code allows a credit against United States taxes for taxes paid to a foreign country (subject to certain limitations), any increase in foreign taxes could be offset dollar for dollar by a reduction in United States taxes.

III. CONCLUSION

29. In this paper the UK Government has analysed the worldwide unitary system by reference to the universally-accepted criteria of a good tax system - equity, certainty, simplicity and the promotion of economic efficiency. It has demonstrated that, when applied in the present international context, the worldwide unitary method inevitably produces results which are inequitable and uncertain. The method involves additional compliance costs for companies. Furthermore it is in the United Kingdom Government's view objectionable in principle that the method can require the disclosure of the records of companies outside the USA, particularly as these will often apply to transactions entirely unrelated to activities within the United States.

30. If the worldwide unitary system is allowed to persist it will hamper rather than promote economic efficiency distorting investment patterns and inhibiting trade throughout the world. It makes it impossible to achieve the essential objective of providing a consistent and coherent international tax framework for trade and investment. This framework is particularly crucial at the present juncture in the development of the world economy, when businesses are seeking profits throughout the world without regard to national boundaries. The narrow economic standpoint of the unitary system is incompatible with the harmonious relationship that is the goal of our governments, to the benefit of the American and British people alike.

Annex B

UNITED KINGDOM GOVERNMENT NOTE

PROPOSED UNITARY TAX LEGISLATION (SB 1974)

Introduction

1. The United Kingdom Government welcome the introduction into the United States Congress on 18 December 1985 of a bill to restrict the use by states of the worldwide unitary method of taxation for corporations. This is a significant step towards resolution of the unitary tax issue and they trust that appropriate legislation will be passed into law and take effect by 31 December 1986. As a contribution to the progress that is now possible the United Kingdom Government wish to comment on the proposed legislation and hope that account can be taken of the particular concerns expressed below.

2. The United Kingdom Government recognise the determination of the United States Treasury to work towards a solution to this long-standing problem; they are encouraged to note that a number of concerns which have been raised previously have been met and that some account has been taken of representations submitted in relation to the proposed Unitary Tax Spreadsheet Legislation published in July 1985.

3. The United Kingdom, however, consider that there are certain features of these new proposals which are unsatisfactory. In particular they are disappointed to note that although taxpayers will receive a new statutory right for a corporate group to be taxed by reference to the water's edge, states will still retain powers to disregard that new right, and that the definition of water's edge used in the Bill will override internationally accepted principles of taxation.

Section 7518

(a) Use of the Worldwide Unitary Method

4. The structure of the section is to prohibit the use of the Worldwide Unitary Method by states while permitting them to make provision for elections by companies to use the worldwide unitary basis if they so wish. This is a sound foundation to the legislation and the United Kingdom Government welcome the express prohibition of the Worldwide Unitary Method as an explicit statement of intent. Nevertheless there are a number of particular points which are giving rise to concern in the United Kingdom and to which the United Kingdom Government wish to draw attention as follows:

i. The section permits the use of the worldwide unitary basis of taxation by states in two designated sets of circumstances. As indicated on previous occasions the United Kingdom believe that there are strong objections of principle against giving states these reserved rights. They believe that it should not be possible to withdraw from a taxpayer, without his consent, the right to be taxed on the basis of internationally accepted principles which have been approved by the US Government in numerous double taxation agreements. In addition, these reserve powers will result in worldwide unitary taxation being used as a sanction and it is not thought that such a penalty is the appropriate means of regulating a tax system. The appropriate sanction for failure to comply with tax legislation is the imposition of some financial penalty. (It is even conceivable that states which do not presently use the unitary method of taxation on a worldwide basis may also wish to do so as a sanction and this may result in more rather than fewer states using it.)

ii. As a practical point, it seems unnecessary to permit the use of worldwide unitary taxation as a sanction if there are already proper penalty provisions available for enforcing compliance. In this context it is noted that Section 6039A provides for financial penalties where there is a failure to comply with spreadsheet legislation and that states are not precluded from imposing fines or penalties for negligence, fraud, or understatement of income. These provisions would appear to render the reserve powers otiose. (We refer to this point again in paragraph 8 below.)

iii. Section 7518(a)(i) permits the use of worldwide unitary taxation as a sanction for failure to comply with the "legal or procedural requirements of the income tax laws" of states. There is much concern that this provision would be used by states to impose inappropriate conditions (for example, an election/entry fee or disinvestment in South Africa), to be fulfilled by particular taxpayers such as multinational corporations, by writing the conditions into the "legal or procedural requirements of the income tax laws" of states. Thus, unless the conditions were fulfilled by those taxpayers the worldwide unitary basis could be imposed.

iv. There are several points of detail relating to Section 7518(a)(ii). First, Governments would not under present arrangements provide information direct to states as appears to be contemplated here. Secondly, the information referred to is not subject to treaty limitations. This is in marked contrast to Section 6103.4(d)(1) which contains the requisite safeguards regarding information exchanged under double taxation agreements. Thirdly, it is not clear which country is contemplated in the phrase "government of the relevant foreign country". Is this the country of residence of the foreign parent company or of other members of the group? Finally, it does not seem reasonable to penalise the taxpayer for a foreign government's failure to provide information. It may not for example be available to the government, or the government may be unable to provide information for example for reasons of national security.

v. States are not precluded from providing for a taxpayer to make an "unconditional election" (Section 7518(a) to be taxed on the worldwide unitary basis. There is some doubt as to the meaning of the term "unconditional" in this context: would it prevent conditions in favour of the taxpayer, for example being permitted to use the election for specific accounting periods, being introduced?

(b) Water's edge definition

5. The United Kingdom Government have consistently maintained that a water's edge solution should be based on the internationally accepted concept of the permanent establishment. They recognise that the definition of permanent establishment in for example the OECD model double taxation convention may require some adaptation for use in state legislation. But, while they welcome the fact that a satisfactory solution seems to have been found for the particular problem of foreign banks, they find it very disappointing that the proposed legislation, by wholly departing from the permanent establishment concept, gives statutory authority to what can only be a damaging derogation from agreed principles of international taxation. It makes it possible for a corporation to be included within a water's edge group, and exposed to state taxation, in a situation where the corporation has no tax presence in the United States for Federal tax purposes. There seems to be no justification for giving state authorities wider taxing rights than the Federal authorities.

6. There are two points which are causing particular concern in the United Kingdom.

i. The definition of worldwide unitary basis permit the inclusion of a foreign corporation in a water's edge group if it crosses certain thresholds. These thresholds, particularly the $m10 threshold (Section 7518(c)(2)(D)), will give rise to burdensome and continuing compliance problems as foreign companies will repeatedly have to compute worldwide factors in order to demonstrate whether or not they cross the thresholds. The $m10 threshold has largely been discarded by those states which have attempted to settle the unitary taxation issue. The United Kingdom regret that what they regard as this small measure of progress by individual states in defining the water's edge group should not be reflected in the Federal proposals.

ii. It is noted that Regulations will be prescribed by the Secretary to determine the definition of "not subject to substantial foreign tax" (Section 7518(c)(3)(C)). As was stated in relation to the Unitary Tax Spreadsheet Legislation published in July 1985 it is important to ensure that countries like the United Kingdom will be protected from any risk of being categorised as tax havens merely because of fluctuations in corporation tax rates.

Section 6039A

7. The proposals relating to the reporting and spreadsheet provisions will have many practical implications for United Kingdom corporations and representatives of British business are making representations on this aspect of the proposed legislation.

8. The United Kingdom Government welcome the improvements which have been made in the provisions since July 1985, particularly the increase in the filing period to 180 days and the uplift in the reporting threshold to $m10. There is, however, some concern that Section 6039A(e)(3) (imposition of penalties under state law) might allow states to impose worldwide unitary taxation as a penalty for perceived transgressions of state tax laws. It is reiterated that, apart from this reservation, the penalties which appear in Section 6039A(e) would appear to obviate the need for states to have reserve powers to impose worldwide unitary taxation for failure to provide information or comply with state legal or procedural requirements. It is not thought appropriate to impose the worldwide unitary basis of taxation as a compliance sanction.

Jurisdiction

9. It is noted that there is no provision in the proposals for the settlement of disputes to any of the matters covered by the legislation. It is presumed, and it would certainly be desirable, that jurisdiction will be conferred on Federal courts rather than on state courts.

Conclusion

10. It is important that the proposed legislation should enjoy the confidence of foreign governments and of multinational businesses and the views expressed in this note arise from the strong desire of the United Kingdom Government to see a satisfactory solution to the present problems relating to state use of the unitary method of taxation on a worldwide basis. On the one hand, the proposals contain a number of features which they welcome, in particular the way in which the problem facing foreign banks has been dealt with. On the other hand, they have considerable reservations about the powers reserved to states to impose worldwide unitary taxation and fear that the legislation could be used by states to obtain more extensive information powers while continuing to impose such worldwide unitary taxation. They also have considerable reservations about the conception of the water's edge definition. They trust that these and other concerns will be addressed in drafting the final legislation.

11. United Kingdom Government officials are prepared to discuss these representations further and could, if it would be helpful, come to Washington for any necessary discussic

Statement of BATUS Inc.

on

S. 1974

Senate Committee on Finance

Subcommittee on Taxation and Debt Management

September 29, 1986

BATUS Inc. (herein "BATUS") is the management holding company for the U.S. business interests of B.A.T Industries p.l.c. (herein "BAT"), a United Kingdom corporation. BAT operates in more than 90 countries and employs over 320,000 people worldwide. It is involved in the four major business areas of tobacco, paper, retailing, and financial services. BAT stock is publicly traded in the United States on the American Stock Exchange in the form of American Depositary Receipts.

The BATUS group of companies employs more than 40,000 people in the United States and includes: Brown & Williamson Tobacco Corporation, the third largest tobacco company in the U.S.; Appleton Papers Inc., the world's leading producer of carbonless copy paper; Saks Fifth Avenue, with 43 fashion specialty stores in eighteen states; Marshall Fields, with 21 department stores in three states; Ivey's, with 24 department stores in three states; Breuners, operating 17 quality home furnishing stores and 42 furniture rental stores in three states; and Thimbles, with its 38 fashion speciality stores in 14 states.

✓Both BATUS and BAT have long been involved in the effort to prohibit the use of worldwide unitary taxation. Worldwide unitary taxation is a method of "sourcing" corporate income to determine which taxing jurisdiction should tax it. State governments in the U.S. have traditionally used a formula to ascertain how much of the income of a single corporation doing business in more than one state should be taxed by each. Most often that formula is the amount of the corporation's payroll, sales, and property in the taxing state compared to all states in which it does business. About one-half of the states apply this method to multicompany groups operating in more than one state. That method is commonly called the "unitary method."

When the application of that method is carried one step further, beyond the "water's edge," and overseas affiliated corporations are included, that method of tax assessment has become known as "worldwide unitary taxation." At the present time, Alaska, California, Montana, and North Dakota continue to use that method of corporate tax assessment. Neither the federal government nor any foreign country uses it, and they are bound by treaties not to do so.

Then Chairman and Chief Executive Officer of BATUS, Charles I. McCarty, served on President Reagan's Worldwide Unitary Taxation Working Group, which issued its report in August 1984. The Working Group agreed on three principles to guide state taxation of multinational corporations: (1) unitary combination for both U.S. and foreign-based companies should be limited to the "water's edge"; (2) increased federal administrative assistance with the states to promote full taxpayer disclosure and accountability; and (3) competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

S. 1974 was drafted in accordance with those three principles. It would prohibit the use by the states of worldwide unitary taxation. It would provide to the states increased assistance from the federal government and the corporate taxpayer so that the states could feel confident that all taxable transactions are subject to taxation. It would require that the states "equitably" tax dividends which U.S. corporations receive from their overseas subsidiaries.

Some will tell this Committee that federal preemptive legislation is not now needed. It is true that since the Working Group issued its report, nine states have repealed or otherwise ceased using worldwide unitary income taxation, and California has most recently enacted legislation which, effective January 1, 1988, would allow corporations to, upon payment of a fee, elect the internationally accepted arm's length approach rather than the worldwide unitary method of calculating their tax base in the state.

However, in addition to not taking effect until then, the California law requires corporations electing not to be taxed under worldwide unitary taxation to pay a special fee, and the tax base for companies that conduct more than 80 percent or more of their business abroad will still be calculated on the combined basis of all the worldwide revenues, not only those generated in or repatriated into California.

Alaska, Montana, and North Dakota also still use worldwide unitary taxation. There is no guarantee that other states cannot adopt it whenever they decide they would like to increase revenue by taxing income generated outside their borders. That motive quickly increased the number of miscreant states from three to twelve in a short period of time after the decision of the Supreme Court in the Container case in 1983. Absent federal preemptive legislation, there will be no obstacle to a repeat of this performance in the future.

Opponents of federal legislation will contend that it violates "states' rights." Actually the basic issue has nothing to do with states' rights, but rather is a straightforward choice of sourcing mechanisms. State, federal, or foreign tax administrators all face the same problem: How much income is earned in their jurisdiction? With the exception of Alaska, California, Montana, and North Dakota, now every state and every foreign taxing jurisdiction uses virtually the same method that the U.S. federal government uses. This method is the separate accounting or arm's-length method. The real debate is over how income is sourced and has nothing to do with jurisdiction to tax, method of tax, or amount of tax.

The Supreme Court has determined that limited indirect federal involvement in some aspects of state taxation is not an infringement on states' rights:

> It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income.[1]

An examination of what federal preemptive legislation would not do clearly indicates that state's rights are not an issue:

1. It would not change state tax jurisdiction. States remain "territorial" taxing jurisdictions free to tax all income that arises within their borders.
2. It would not affect the level or rate of state tax. Once income is sourced within their borders, states are free to tax at any rate and by any method they choose.
3. It would not affect taxation of income that arises from sources inside the U.S. Income earned in the U.S. is unaffected.
4. It would not require the states to adopt a uniform apportionment formula. States may apportion U.S. source income under any reasonable formula.

As Secretary of State George P. Shultz pointed out in his January 30, 1986 letters to the Governors of Alaska, California, Idaho, Montana, New Hampshire, and North Dakota:

> Continued state taxation on a worldwide unitary basis will greatly impair the ability of the federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies.

S. 1974 was drafted in accordance with the principles adopted by the President's Worldwide Unitary Taxation Working Group. It was introduced at the President's request in accordance with this country's economic and foreign policy as specified in the

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[1] Moorman v. Bair 437 U.S. 267, 280 (1978).

President's statement of November 8, 1986.2/ It would solve the problems that use of worldwide unitary taxation by states poses for the federal government, its international trading partners, and U.S. and foreign multinationals. It would remove a disincentive to investment in the U.S. and increase the efficient allocation of resources and employment opportunities for Americans. It should be acted on favorably by this Committee, and ultimately be passed by the Senate and the House of Representatives. Only federal legislation, such as S. 1974, can offer a lasting solution to this "difficult and long-lasting issue," as Secretary of State described it in his letter.

2/ 45 Weekly Compilation of Presidential Documents 1368.

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VALENTINE BROOKES
LAWRENCE V. BROOKES

September 22, 1986

Committee on Finance
United States Senate
Washington, D. C. 20510

Honorable Senators:

This letter contains my statement of support for the passage of S. 1974, relating to state worldwide consolidated unitary tax formulae, with amendments I shall suggest are needed for it to accomplish its purpose. This statement is submitted on behalf of Capitol Industries-EMI, Inc., a California corporation, headquartered in Hollywood in that State, the stock of which is entirely owned by a corporation of the United Kingdom, Thorn EMI, P.L.C. Capitol has been operating from its California base for more than 30 years, and was an established corporation with substantial properties and sales at the time of its acquisition by the forerunner of its present parent corporation.

On behalf of Capitol I have appeared before the Senate Foreign Relations Committee in 1977, endorsing the ratification of the United States-United Kingdom Income Tax Convention with Article 9(4) as an integral part of it, and I was invited to appear before the Task Force of the Working Group which the Administration formed to study the unitary tax problem and make recommendations of solutions in 1983. On behalf of Capitol and of EMI I have also been attorney of record in litigation in the federal courts to oppose the application of California's worldwide unitary formula in a manner to include the operations, and property, payroll and sales, of EMI itself and of its non-U.S. subsidiaries in a unitary group headed with its American subsidiary, Capitol.

The consolidation of a domestic subsidiary with the foreign parent turns the unitary theory on its head. The unitary theory assumes that the income of the other corporation is substantially owned by the California taxpayer, which is an assumption contrary to any conceivable fact when the California corporation is the subsidiary and the foreign corporation is the parent with the necessary controls of the subsidiary's operation and the disposition of its income which that relationship embodies. California could not tax dividends received by EMI from Capitol, whereas if the roles were reversed, it could tax the dividends paid by EMI to Capitol. Hence where the parent is foreign there is not the justification for including foreign operations conducted by separately incorporated subsidiaries in the unitary group headed by the parent, which the Supreme Court found in the case of a consolidated unitary group with both foreign and domestic operations, the domestic parent being the taxpayer. The situation the Committee is now considering, however, because of the recent adoption by California of its peculiar relief measure, applies only where the facts are turned on their head and the flow of dividends is from the domestic subsidiary to the non-taxable foreign parent, and the California taxpayer, the subsidiary, has no conceivable legal or operational controls over the foreign operations or benefit from the foreign income which would be consolidated with it under the California formula.

So much has been presented to the United States Senate on this subject, the constitutional invalidity, and the foreign policy imperatives, all arguing against a continuation of the combined worldwide unitary system, particularly where the parent corporation is a foreign corporation, that I need not go further. I shall turn now to the new California statute.

California's new legislation does nothing to end the double taxation of the foreign income which results from its refusal to allow either a deduction or a credit for the foreign taxes on foreign income. This has been one of the most resented features of the California system, except for those corporations which can afford to elect out of the worldwide unitary system.

California's new legislation continues to keep it out of step with most other states. In 1966, California, like most other states taxing corporate income, adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Most of the adopting states did not interpret that Act as requiring the automatic worldwide consolidated unitary system, but California did, thereby destroying the uniformity among the adopting states the title of the Act reveals was its objective.

The new California relief measure is not an acceptable solution. It permits corporations such as Capitol to elect out of the worldwide unitary formula, at the cost of an election paid for by an annual fee calculated without regard to net income. Though the California franchise tax is based on net income, the price which must be paid under this new statute to elect out of the worldwide consolidated unitary formula is the payment of a fee based entirely on the sum of the taxpayer's property, payroll and sales in California. The sum of Capitol's property, payroll and sales in California is $400,000,000, and the resultant fee would be $120,000 a year, for 10 years, or a total of $1,200,000.

Since the unitary tax is based upon net income and not every year is a good year for business, the annual cost of the worldwide unitary tax is less than that sum. For example, Capitol is challenging the unitary tax in the California legal system for the years 1968-1974, inclusive, and the total tax is dispute is $444,322. That averages out to less than $89,000 a year, compared with $120,000 to elect out of the system. This is a convincing demonstration of the fact that California's cure is worse than its disease.

Capitol's situation cannot be unique. It will be shared by every California subsidiary of a foreign parent which has been in business substantially in California prior to 1986. The property, payroll and sales of that subsidiary will be the subject of this election fee, and while the percentage is small arithmetically as an abstraction, when multiplied by the large figures that are produced by adding the cost of property, payroll and gross sales into a product which is multiplied by the rate of the fee, the figures will always be large, and we suspect that in most instances the fee will exceed the unitary tax which is being avoided by paying the fee, which will result, presumably, in many decisions not to make the election.

The beneficiaries of this scheme will be those corporations which have had only minor operations in California, have withheld enlarging them because of the unitary tax, and are induced to locate heavily in California in order to keep the election fee to a minimum, or eliminate it altogether. This is because new property added after January 1, 1988, and new payroll added after that date, will in sum reduce the measure of the fee. Many Japanese corporations informed the California Legislature of their anxiety to add new facilities in California if the unitary system was done away with, and presumably they will be able to reduce the fee to an insignificant amount. They may not be able to reduce it altogether, because the relief obtained from adding new plants will not be complete unless the value of the plants and the size of the added payroll, greatly exceed what was there before. The reason for this is that the fee is based on the sum of sales, and property and payroll, and the relief provision is only based on the sum of payroll and property. Sales, usually the largest figure of the three, are not included in the relief computation. However, the Act is clearly designed to give relief to those that build new plants in California, and to withhold it from those that already had large investments in California.

The California Act is thus a blatant attempt to attract new industry, and have the cost of the attraction paid by those domestic subsidiaries that were already well established in California and do not need to enlarge their plants and operations in California. The legislative history of the Act shows that the California Legislature was determined that the adoption of the water's edge principle should not cause a loss of the revenue heretofore obtained through what we believe is the unconstitutional taxation of foreign parent corporations so the election fee to be paid for the privilege of adopting the water's edge principle was designed to finance the resulting loss of revenue. The Legislature was made conscious by intense lobbying efforts of some foreign interests that the election fee would inevitably deter new investment in California unless something was done about that, so the California Act permits the reduction of the fee, as I have stated, measured by the new plant and payroll added after 1988. The lag in effective date prevents any corporation from benefiting which had a new plant under construction at the time of the adoption of the new Act. Capitol sees this situation as a rank discrimination against those taxpayers that have been supporting the California economy in the past and a probably unconstitutional discrimination, particularly since foreign commerce is involved. Aside from its doubtful constitutionality, this situation is deplorable foreign policy. Foreign policy is something which the United States is supposed to have exclusively, and a state is not supposed to have at all. We urge the United States government to exercise its constitutional power and by this statute state the conditions on which the states may tax net income from the United States end of foreign operations.

In the recent past, responsible officials of the Treasury Department, including one or more at the Assistant Secretary level, have stated publicly that the attachment of conditions such as this fee to a California water's edge measure would be unacceptable to the Administration, and would not remove the need for the adoption of this federal legislation. One of these letters was written to the minority leader of one of the Houses of the California Legislature, in response to a letter from that legislator. Clearly it was intended to state the Administration's position in a manner that would get the news to the California Legislature, but equally clearly it was not sufficient to deter the California Legislature from proceeding to adopt a measure which conflicts with the stated federal condition for regarding the unitary blight as eliminated.

Accordingly, we regard the federal legislation as an imperative, no less so now that the California statute supposedly designed to remove the problem has been adopted. All foreign investment through local subsidiaries should be protected from the exaction all other nations regard as abhorrent, not merely that which appears in California after 1988. On behalf of

Capitol Industries-EMI, Inc., an American corporation owned by a United Kingdom parent, I urge the approval of S. 1974.

However, I do urge the Senate to consider an amendment to the section of the Internal Revenue Code which that measure would adopt. I fear that as drafted the measure will be self-defeating. I have previously written the Senate author of the bill to this effect, with copies to the corresponding author of the House bill and to the Secretary of the Treasury, but I have not been informed that any effort has been made to provide an amendment, nor have I received any response to inform me that my concern is overdone. The prohibition against the worldwide unitary method is contained in proposed Section 7518, but it provides that a State may continue to impose such a tax if either the taxpayer or "the government of the relevant foreign country" does not provide to the taxing State "material information" related to the determination of allocable income. One of the objections to the worldwide unitary system, particularly acute when the group is headed by a foreign parent, is that much of the information the states routinely request is beyond the reach of the American subsidiary. It relates to foreign events, foreign properties, and may be entirely unobtainable even by the parent, since the parent does not need to have that information for its own purposes and hence does not obtain it from its own offshore subsidiaries. Furthermore, foreign governments adopt legislation for their own purposes, to deal with their own problems, and not for the purpose of making California's lot either easier or harder.

Capitol Industries- EMI, Inc., is an example of what a subsidiary of a corporation of such a country faces. In Great Britain there has been, since before World War I, legislation entitled "The Official Secrets Act." From some time before World War II, EMI, the predecessor of Thorn EMI, Inc., has been an important defense contractor for the government of the United Kingdom. Its operations are subject to the restrictions and restraints in the Official Secrets Act. Violation of the restraints in that Act is a criminal offense. The responsible officer of EMI, Inc., charged with ensuring the compliance by his corporation with the provisions of the Official Secrets Act, has testified that the release of the type of information California requested of that corporation would violate the provisions of the Official Secrets Act, because some of the plants are restricted by the statute and so certified by the Ministry of Defence. The problem arises because many of the facilities certified as restricted by the Ministry of Defence are used interchangeably in defense procurement and in the manufacture of musical recordings. Capitol is involved only in the musical recording end of the business, so EMI's music recording business in the United Kingdom and elsewhere is the one which the Franchise Tax Board of California now regards as a single unitary business, combined with Capitol. The Franchise Tax Board wants to sever the defense business from the music business, but facilities cannot be severed in that manner. The information about the property values and payroll of such a facility are entirely restricted, including the portion about which California wishes information. It follows, unfortunately, that Capitol cannot provide the State of California with information that state regards as "material" relating to operations within the United Kingdom, and hence it is doubtful to me whether Capitol would be protected by the proposed federal statute in the form in which it is now drafted. I do not believe that Capitol is alone.

Furthermore, there is nothing in the statute to settle the question who is to determine whether the information the State wants is "material", and in the past California has regarded all information about the parent corporation and its offshore subsidiaries as "material". Indeed, the extent of the unitary authorities' demand for foreign source information is a significant part of the outcry against the worldwide consolidated unitary formula. There is therefore grave danger that if the provisions of Section 7518(a)(2), as now drafted, are not deleted or significantly changed, the result intended by the Senate to be obtained by the adoption of the statute will be frustrated. The problem I see is not confined to non-disclosures because of foreign statutory prohibitions. It extends also to the Franchise Tax Board's unbending insistence that transactions between two foreign subsidiaries, not involving any commerce with the United States at all, be included in the information to be submitted to the Franchise Tax Board. I cannot explain this and express my concern about it better than I did in my letter to Senator Wilson, (R) (This was reprinted in full text in Tax Notes for January 20, 1986, p. 282), from which I quote a portion:

> "I recognize that the states are entitled to information which will permit them to administer section 482 types of adjustments, including the determination of whether fair prices are being charged in intra-group transfers, but this subdivision is not so limited. It could require Capitol Industries-EMI, Inc., to inform the Franchise Tax Board of all "material information" about sales between EMI's Italian subsidiary and its French subsidiary, and other intra-group transfers entirely outside the United States and to which Capitol was not a party ("transactions between . . . any related corporation described in section (c)(2) . . . and any corporation . . .

which is a member of the same controlled group . . . .") As drafted it is definite overkill.

"In a sense the states'conduct in prevailing on a minority in the Senate to defeat Article 9(4) has cut them off from help they might otherwise obtain. The treaties obligate each signatory nation to assist in obtaining needed information, and the states are not presently beneficiaries of the treaties.

"With deference, I suggest the inclusion of" the government of the relevant foreign country" in the category of bad boys, as the present draft of section 7518(a)(2) does, is quite indelicate. It will exacerbate already held resentments among many foreign governments, because it implies they could be parties to a deliberate plan of suppression to avoid state taxes which would be proper taxes under the new act."

I think there is sufficient protection to the states in section 7518(a)(1), and I believe that subsection (2) could quite properly be deleted altogether.

Respectfully,

Valentine Brookes

Valentine Brookes for
Capitol Industries-EMI, Inc.

VB:hj

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARINGS ON S.1974 AND S.1113
29 SEPTEMBER 1986

WRITTEN STATEMENT IN SUPPORT OF S.1974
ON BEHALF OF
THE CONFEDERATION OF BRITISH INDUSTRY
LONDON, ENGLAND

STATEMENT ON BEHALF OF THE CONFEDERATION OF BRITISH INDUSTRY TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE UNITED STATES SENATE COMMITTEE ON FINANCE IN SUPPORT OF S.1974 - HEARINGS 29 SEPTEMBER 1986

PART I - INTRODUCTION

1 This statement[1] is submitted on behalf of the Confederation of British Industry ("CBI"). The CBI speaks for British business, representing directly or indirectly well over 250,000 firms and organisations with over 12 million employees. Our members are drawn from all sectors of British business and they range from the largest multinational companies to very small concerns.

Basic Position of British Business

2 The CBI has long opposed worldwide unitary taxation ("worldwide unitary") and its departure from the accepted separate accounting basis of international taxation and has, previously, testified in detail against it to Congress, to the federal Worldwide Unitary Taxation Working Group and to the Californian and other state legislatures.

3 We have welcomed the moves in some states over the past months to roll back worldwide unitary. Most recently, we have noted the passage last month of legislation in California. These developments represent stages in the process towards removal of the worldwide unitary problem. But, as we explain below, the California legislation contains basic shortcomings and the solution which has been sought has yet to be provided. It remains our belief that only federal legislation can provide the universal, certain and enduring solution to meet the concerns repeatedly expressed by international business and the many national governments which, individually and collectively, have consistently and repeatedly pressed the federal government to bring an end to the problem of worldwide unitary. We continue to believe therefore, despite the developments in California and elsewhere at state level, that early federal legislation remains an urgent necessity. Accordingly we wholeheartedly support the enactment of S.1974 which we believe can, with a few modifications, provide a quick end to the international problems created by the use of worldwide unitary.

PART II - THE OBJECTIONS TO WORLDWIDE UNITARY TAXATION

4 The CBI's long-standing opposition to worldwide unitary is based on the widely-held objections with which the Committee will already be familiar. It is of particular concern to us that -

i Worldwide unitary is at odds with separate accounting and the arm's length principle which govern US federal taxation, domestic and international taxation across the world, and the international treaty obligations of the United States.

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[1] This statement constitutes a summarised version of our full position on worldwide unitary taxation. We would be very pleased to discuss our views in more technical detail with the Committee or its technical advisors and to supply copies of the detailed and extensive evidence which we have tendered on worldwide unitary in previous years.

ii The methodology of worldwide unitary is such that it distorts tax liabilities, results in double taxation and creates extensive uncertainty for business.

iii Worldwide unitary imposes onerous and often impossible compliance burdens, particularly for foreign-parented companies.

iv It thus threatens and inhibits the free and orderly development of international trade and investment.

v Further, it sets a dangerous precedent which other countries could be tempted to follow in an endeavour to maximise their revenues at the expense of US and other foreign investors.

A brief elaboration of these concerns is contained in the Appendix to this statement.

5 These and other objections form the basis of the widespread opposition to worldwide unitary which has been increasingly voiced in recent years by US and foreign international business; by business-representative bodies such as ourselves, the International Chamber of Commerce, UNICE, and the Business and Industry Advisory Committee to the OECD (BIAC); by numerous foreign governments and by the European Community and the OECD. Legislative, judicial and administrative hearings at both federal and state levels over many years reveal a forthright and consistent pattern of opposition.

6 To this is to be added the clear and unequivocal opposition of the US federal administration, as evidenced particularly by President Reagan's statement of 8 November 1985 and the issuing of the draft federal legislation, since reinforced by the amicus curiae briefs of the United States (and seventeen foreign governments) in the cases of Alcan Aluminium Limited and Imperial Chemical Industries PLC v The Franchise Tax Board of the State of California.

PART II - THE CONTINUING NEED FOR FEDERAL LEGISLATION

7 It is the international dimension of the impact of worldwide unitary which by definition demands a federal solution to the problem. Only the federal authorities are competent to enter into international relations with foreign governments on fiscal matters such as information exchange. Equally, only federal legislation can provide protection which embraces all states and affords uniform treatment across the United States. With such a solution in mind the CBI warmly welcomed President Reagan's 8 November 1985 announcement of federal legislation which would -

> "... effect a requirement that multinationals be taxed by states only on income derived from the territory of the United States ("the water's edge requirement")..."

8 Some states have already acted to repeal worldwide unitary. Some, such as California, have introduced measures which do not fully meet the terms of the President's statement and fall well short of satisfying international concern, and others have not acted at all. Individual states may or may not introduce and repeal their own local legislation from time to time. The piecemeal approach to worldwide unitary by different states illustrates the need for a universal federal solution. The international community needs to be confident that wherever business is conducted in the United States there will, at the least, be a uniform and lasting protection against worldwide unitary based on common concepts, definitions and reporting obligations.

9 This is well illustrated by the "water's edge" bill passed by California only last month. At a general level, it applies inevitably only to California. As we have mentioned, other states have adopted different measures and others none at all as yet. More specifically, as a remedy in California itself, it is fundamentally unsatisfactory in three respects. First, in sharp contrast to S.1974, far from repealing or prohibiting its mandatory use it leaves worldwide unitary firmly in place as the established primary basis for taxation in California. "Water's edge" is structured only as the secondary, elective, basis. Second, it provides little certainty since it empowers the authorities to disregard a company's "water's edge" election in a wide range of circumstances and to impose worldwide unitary retroactively and against the company's will. Finally, it levies an additional impost on any company wishing to elect by requiring it to enter into a ten-year rolling contract to pay the state an annual fee calculated as a percentage of its California payroll, property and sales.

10 It is clear to us that in these circumstances federal legislation is the only effective remedy.

PART III - THE CBI's COMMENTS ON S.1974

12 The broad thrust of S.1974 is welcome and those features which create particular difficulties for British business can we believe be met by relatively modest drafting changes.

13 We have three major areas of concern about the scope and effectiveness of S.1974, concerns which have been heightened rather than allayed by the recent Californian legislation -

A The retention by individual states of residual powers mandatorily to impose worldwide unitary on taxpayers (though to a much more limited extent than the Californian legislation).

B The conditionality of taxpayer relief from worldwide unitary.

C The mismatch between the definition of the "water's edge" delimitation of states' tax jurisdiction in the Bill and existing international taxation principles.

A The Retention by Individual States of Residual Powers Mandatorily to Impose Worldwide Unitary Taxation on Taxpayers

We do not believe, as a matter of principle, that such powers are consistent with a true "water's edge" solution, nor with a framework of arrangements - of which S.1974 forms part - in which such a key element is to give states access to taxpayer information obtained under international tax treaties. Secretary Baker's 5 March 1986 letter to Senator Packwood refers to S.1974 as legislation which would -

> "...generally prohibit states from imposing corporate income tax on a worldwide unitary basis..." (emphasis added)

This is the cornerstone of effective relief.

The objective must be to provide taxpayers with an unfettered right to be taxed in accordance with international principles already accepted and applied by the United States itself, and to be relieved clearly and unequivocally from all threat of mandatory worldwide unitary. Unfortunately, as drafted, S.1974 allows states to impose worldwide unitary against the wishes of taxpayers for failure by them or foreign governments to provide certain information and for other possible infringements of the legal or procedural requirements of states' tax laws.

It would be astonishing if, by including such powers in S.1974, mandatory worldwide unitary actually appeared to be sanctioned by federal legislation, contrary to the Administration's stated intent and public position on the matter. If enacted as it stands S.1974 would for the very first time enshrine federal acceptance of that system.

We urge that S.1974 be modified to delete all references to these powers and to make clear that taxpayer default in relation to information or other matters will carry only the usual sanctions in tax matters of monetary or, where appropriate, criminal penalties at federal and state level. We further suggest that in fairness taxpayers should not be penalised at all for the failure of foreign governments to provide information or for their own inability under foreign national security law to do so.

B The Conditionality of Taxpayer Relief from Worldwide Unitary Taxation

To provide a satisfactory solution to the worldwide unitary issue and to give practical effect to the President's expressed intent, protection from that system in the form of "water's edge" treatment should be available to taxpayers as an unfettered right.

S.1974 should unequivocally prevent local tax authorities from imposing their own individual preconditions to the availability of "water's edge" treatment, whether those preconditions take the form of payment of an annual or entrance fee on top of ordinary business taxes, the surrender or waiver of legal rights or any other form and whether directly expressed in state unitary legislation or buried in the general corpus of state tax law.

C The Mismatch between the "Water's Edge" Delimitation of Tax Jurisdiction in the Bill and Existing International Taxation Principles

Worldwide unitary taxation does not separate non-US from US activities in line with US federal and internationally accepted taxation principles. S.1974 attempts to do this by imposing the "water's edge" limitation on the unitary method.

Unfortunately the draft definition of "water's edge" in S.1974 does not marry up with the permanent establishment concept of territoriality already established in international taxation and used in the United States' (and the United Kingdom's) own double taxation treaties and by the model treaties of the OECD and United Nations.

This would be sufficiently remedied by bringing into S.1974 the rules which the United States already uses in federal taxation for identification of US operations for both tax reporting and computational purposes. It would also allay a further fear that the proposed information reporting rules in S.1974 could be interpreted as extending to foreign companies in a foreign parented group which are not subsidiaries of US companies in a "water's edge" group, and possibly even to the foreign parent itself, a result which would vitiate S.1974.

Conclusion

British business believes that worldwide unitary taxation is wholly inappropriate as a basis for the taxation of trade and commerce across national frontiers; that the recent Californian legislation, being seriously deficient in a number of respects, does not solve the problem; that worldwide unitary taxation raises problems of international dimension which only federal legislation is competent to remove effectively and that S.1974 modified on the lines outlined above would provide a satisfactory, universal and enduring solution to the current difficulties.

The CBI therefore commends S.1974 to the Committee.

APPENDIX

Explanation of the Objections to Worldwide Unitary Taxation

I Worldwide Unitary Taxation is inconsistent with existing international taxation principles based on separate accounting on the arm's length principle.

Where a company operates across national boundaries rival claims of competing tax jurisdictions have to be resolved by some mechanism. "Arm's-length separate accounting" is long established and adopted as the appropriate mechanism by the federal government and other nations throughout the world, as well as by the OECD and UN model tax treaties. Each foreign company operating in a country or territorial sub-division is taxed there separately as an independent enterprise. In its transactions with its parent company or other affiliates it is treated for tax purposes as if it were dealing at arm's length.

Unitary taxation, historically devised as a method of allocation of taxable capacity within the USA, and not worldwide, does not recognise the local profits actually earned by each company. It is not a uniform system since different states use a variety of formulations and many have never sought to apply it all beyond the United States, that is worldwide, which is where the international problems are created.

Separate accounting, the longstanding federal and international norm, and worldwide unitary taxation are incompatible. At the international level worldwide unitary is simply out of step with international standards.

II Worldwide unitary taxation is economically unfair, and creates double taxation and uncertainty for business

a Unitary tax produces serious unfairness in the international sphere. The essential underlying theory of unitary taxation, that a dollar of payroll, property and sales produces roughly the same taxable return in different tax jurisdictions, is not valid outside the USA where economic conditions, risks and costs vary enormously. It overallocates profits earned in the whole world to those jurisdictions with higher values of payroll, property and sales factors regardless of actual profitability commercially measured.

b By bringing in activities of foreign affiliates when determining income attributable to a local company in a state, worldwide unitary can tax the company on more than its actual local income, can convert local losses into notional taxable profit, and can produce unrelievable double taxation. Unlike the separate accounting method, it is not coupled with relief for foreign taxes paid. It is, in effect, a tax charge on the affiliates even though they have no US presence. Multiple taxation of the same profits is inevitable if worldwide unitary is applied in some US states but the rest of the world, and the US federal authorities, apply the separate accounting system.

c For business the separate accounting method by its recognition and acceptance throughout most of the world provides an element of predictibility and stability which is so important for business decision making and forward planning. In making investments and planning decisions businesses need to have regard to local conditions. Worldwide unitary introduces extraneous elements into the tax calculation which create uncertainty as to investment returns, since the size of the tax bill is made to depend directly on circumstances extraneous to the state and totally unrelated to the in-state activity.

iii Worldwide unitary taxation creates disproportionate and impossible compliance burdens

Tax authorities using worldwide unitary demand information and records of foreign companies and their subsidiaries outside the USA not related to activities in the USA, both to decide whether to classify them as "unitary" and then to carry out a unitary assessment. Much of this data is neither required nor kept by foreign companies for commercial purposes or for federal, home nation or other international tax compliance purposes. Its production creates additional and often disproportionate compliance burdens, exacerbated by the costs of adjustment to the particular requirements of individual states.

Where the information does not exist at all, or where it cannot be revealed for reasons of foreign national security, a company may be forced to submit to a unitary assessment regardless of its merit simply because the relevant data cannot be made available. The problem would be multiplied enormously if the unitary tax approach were to spread to more jurisdictions each of which imposed its own special information and compliance obligations.

iv Worldwide Unitary Taxation threatens the free and orderly development of world trade

Separate accounting with uniform rules and standards developed over many years, provides a consistent and coherent tax framework for the development of international trade and investment. Worldwide unitary threatens that stability by introducing incompatibility, unfairness and distortive double taxation.

Secretary Baker's 5 March 1986 letter, previously referred to, also records that fourteen of the United States' major trading partners confirm that worldwide unitary constitutes "...a serious obstacle to the development of our trade and investment relationships..."

v Worldwide unitary taxation creates a dangerous precedent

Worldwide unitary, if perceived as approved and endorsed by the United States or even a state with such enormous economic power as California, in the face of international opposition, could provoke emulation by other countries. Obviously they would be intent on maximising their revenues and could devise their own formulae and factors designed to bear most heavily on US and other foreign investors. Any departure from separate accounting in the international tax field could prove the precursor to fiscal chaos.

TESTIMONY TO SENATE FINANCE COMMITTEE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

BY

NANCY J. ORDWAY
CHIEF DEPUTY DIRECTOR
DEPARTMENT OF FINANCE
STATE OF CALIFORNIA

Mr. Chairman and distinguished members of the Subcommittee, on behalf of Governor Deukmejian, I would like to thank you for providing the opportunity to express our opposition to S. 1974 and S. 1113.

When President Reagan was Governor of California, he wrote: "One of the great strengths of our Federal-State system is the freedom of the States to act to meet their own particular problems in the ways that seem best to them; interference by the federal government with the State's power to tax would be a major blow to such freedom."

I do not believe there is a person in this room, knowledgeable about the history of this country and the workings of our federal system, who could quarrel with the President's statement.

California has used the worldwide method of taxation for more than two decades. Other states have also adopted this method. Normally, choices made by California and other states with regard to the taxation of multinational business would be of no concern to the federal government. However, on rare occasions, state tax practices may impact or have resonances on areas which are of principal concern to the Federal government.

In recent years, our foreign trading partners have expressed concerns to the federal government about California's use of the worldwide unitary method. These expressions of concern led to the consideration of federal legislation and tax treaty treatment of the issue, all of which have been rejected.

In March of 1983 the Advisory Commission on Intergovernmental Relations, after an extensive study of state tax practices regarding multinational corporations, concluded that the federal government should only intervene in state tax matters upon a showing of "serious national harm."

In June of 1983 the United States Supreme Court in Container Corporation of America v. Franchise Tax Board (463 U.S. 159) held that California's use of the worldwide unitary method "while it had foreign resonances...did not implicate foreign affairs."

In September of 1983 President Reagan and then Secretary of the Treasury Donald Regan approached the issues raised by our foreign trading partners in a rational manner by inviting public and private sector representatives to participate in a Working Group to resolve this very complex problem. This approach was consistent with the President's view of the proper function of our federal system of government. Governor Deukmejian, sharing the President's view, accepted his invitation to participate in the Working Group.

During the months of study and discussion, it became very clear that no one formula would be acceptable to all the participants. The members of the Working Group unanimously agree to principles which would guide state taxation with respect to the income of multinational corporations:

> Principle One: Water's edge unitary combination for both U.S. and foreign based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

Secretary Regan, in his transmittal letter of July 31, 1984, stated that issues of foreign source dividends and so-called 80/20 corporations were to be "left for resolution at the state level in accord with Principle Three."

The bills that are before you today were introduced because of foreign countries' concerns, expressed to the federal government, with the way California and certain other states tax foreign multinational corporations.

The concerns expressed by foreign multinationals and their governments with respect to California's use of the worldwide unitary method involve questions of compliance costs and the taxation of income reported by them as being attributable to sources outside of the United States.

I would ask this subcommittee to consider whether the concerns originally expressed have been answered. Upon inspection I believe that you will find that they have been. During the last three years, nine of the twelve states which used worldwide combined reporting have modified their tax law to meet the principles agreed upon by the Working Group. Earlier this month, California, after two years of legislative discussion and debate, adopted Senate Bill 85. This bill (copy attached) complies with the agreed upon principles and basically does the following:

- allows multinationals, whether foreign or domestically based, to elect to exclude their foreign activities from the unitary method
- provides dividend relief for domestic-based multinationals
- provides necessary compliance tools for California to audit multinational tax filings.

The three remaining states continue to discuss and debate solutions which would be acceptable to them and consistent with the principles of the Working Group.

A year ago this type of restrictive federal legislation may have seemed necessary to some. Today, the need no longer exists. As President Reagan in writing to a member of this body while Governor of California concluded: "Federal intervention in the interstate taxation field is both undesirable and dangerous and should only be considered as a last resort."

The wisdom of his statement has been demonstrated by recent events which have solved the problem and obviated the need for the last resort.

PROPOSED UNITARY TAX LEGISLATION - S 1974 & H.R. 3980
US SENATE FINANCE COMMITTEE
HEARING BEFORE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SEPTEMBER 29, 1986

STATEMENT OF THE DUTCH EMPLOYERS' FEDERATION (FEDERATION OF NETHERLANDS INDUSTRY (VNO) AND NETHERLANDS FEDERATION OF CHRISTIAN EMPLOYERS (NCW)

(Raad van Nederlandse Werkgeversverbonden VNO en NCW;
Verbond van Nederlandse Ondernemingen en Nederlands
Christelijk Werkgeversverbond)

1. Description of VNO and NCW: This statement is submitted by the Dutch Employers' Federation (Federation of Netherlands Industry (VNO) and Netherlands Federation of Christian Employers (NCW); abbr. VNO/NCW). The Dutch Federation, with its seat at The Hague, represents more than 10.000 enterprises and most of the various representative bodies and associations for specific industrial or commercial sectors in the Netherlands. VNO/NCW welcome this opportunity to present their views on recent California legislation aimed at limiting the scope of worldwide unitary taxation and to submit evidence in support of S 1974. The views of VNO/NCW on this matter are supported by their entire membership.

2. Importance of Dutch investment in the USA: In recent history the Netherlands have been one of the largest investors in the USA and in some years even the largest. This reflects the strong economic ties generally between the USA and the Netherlands. Understandably VNO/NCW have been following the developments around the worldwide unitary method of taxation with concern for many years.

3. Current legislation in California not a complete cure: Although recent legislation in California (S.B. 85) is a significant step in the right direction it falls short of curing essential aspects of worldwide unitary taxation that have been causing widespread international concern for so many years now. Essentially, the California legislation does not displace worldwide unitary taxation. The worldwide basis will remain the primary basis for taxpayers considered by the tax authorities to be "unitary". The "water's edge" basis is secondary, and elective. Further, the California legislation fails to recognize that taxpayers must have the unconditional right to elect to be taxed on the water's edge basis. Worse still rather than be available as of right the water's edge method can only be applied if an annual fee is paid. Finally, the state retains the power to impose the worldwide unitary method mandatorily by way of sanction in a range of circumstances in which a normal financial penalty would be appropiate (and indeed to combine imposing worldwide unitary with such financial penalties).

4. Federal legislation must be the solution: VNO/NCW are of the opinion that federal legislation is a prerequisite for arriving at an adequate solution. Indeed, the fact that the California legislation falls short in the important aspects referred to above only reinforces this belief. Federal legislation will ensure that taxpayers are taxed on a basis that is generally accepted, both federally and internationally.

   VNO/NCW urge the Committee to give favourable consideration to S. 1974 and to contribute to its rapid progress through Congress.

5. Comments on S. 1974: VNO/NCW refrain form detailed comment, but mention two issues.

   The current text of S. 1974 would still allow mandatory application of worldwide unitary taxation in certain situations. Noncompliance with onerous requirements such as the election fee in California legislation may still lead to imposition of worldwide unitary taxation. Furthermore, the present definition of the water's edge includes within that edge certain foreign corporations that under the text of the internationally accepted permanent establishment rules would not have a permanent establishment in the USA.

   VNO/NCW urge that these aspects of S. 1974 be amended so as to provide full protection against worldwide taxation and to restrict the taxation powers of the individual states to income that is derived from United States territory.

6. Support for statement by International Chamber of Commerce: VNO/NCW are members of the International Chamber of Commerce. They fully support the statement by that organization, laid down in a document No 180/278, which your Committee will have received as written testimony. VNO/NCW request the Committee to take the statement of the International Chamber of Commerce into account as a reflection of the deep felt and widespread international concern that will continue until clear and guaranteed protection against worldwide unitary taxation is achieved.

STATEMENT

We welcome this opportunity to comment on the Unitary Tax Repealer Act, ("the Bill") S. 1974 (companion bill H.R. 3980). As a major international accounting firm, Ernst & Whinney is aware of the problems raised by worldwide unitary taxation. Our testimony will comment on some basic policy questions and concerns that are raised by this major piece of federal legislation. We will first discuss broad general issues, then direct our testimony to some of the technical issues raised by the Bill.

I. General Concerns.

A. The Bill Should Only Address the Problems Arising From the States' Use of Worldwide Unitary Combination.

The origin of the Bill arises out of the controversy surrounding the states' use of worldwide combined reporting. Assuming that the purpose of the Bill is to deal with the problems created by the states' use of worldwide combined reporting, the proposed legislation is overbroad and falls unfairly on taxpayers which were never directly or substantially affected by this issue. The reason for this is, in part, because the reporting requirements of the Bill are not limited to multinational taxpayers. Taxpayers which meet the Bill's definition of a reporting corporation, notwithstanding that they have no international activities nor have ever been subject to worldwide unitary taxation, must suffer the burden of completing the disclosure spreadsheet without enjoying any benefit from the demise of worldwide combined reporting. This seems particularly unfair since in the past non-multinational taxpayers may have been led to believe that their interests were not involved in the Working Group's deliberations*; and, the Working Group's members themselves primarily included business representatives from the largest multinational corporations in the United States.

The only reporting requirements that should be imposed by a Bill aimed at dealing with worldwide unitary taxation are disclosures concerning multinational taxpayers. Restricting the use of worldwide unitary taxation without providing the states with disclosure information may create an undue burden on the states' resources to gather data they had previously relied upon concerning the operation of multinational taxpayers. Likewise, however, restricting the use of worldwide unitary taxation has absolutely no bearing on the states' need for such information from non-multinational taxpayers. Although the states may be legitimately concerned about tax evasion by multistate taxpayers, and requiring these taxpayers to complete a disclosure spreadsheet may facilitate compliance, such concerns are generally unrelated to the problems created by worldwide combined reporting and cannot be logically incorporated into federal legislation aimed at addressing worldwide unitary taxation. Additionally, because states have a right to most if not all the information required by the Bill from non-multinational corporations, one major effect of the spreadsheet will be to shift the compilation and analysis of this information from state tax auditors, where it has always rested, onto such non-multinational taxpayers. Putting aside until later the question of whether taxpayers' administrative costs outweigh the states' benefits, this altered relationship raises important policy questions which must be addressed. For example, what effect will this Bill have on voluntary tax compliance and our federal, state and local tax systems of self-assessment?

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* The Working Group's charge was to produce "recommendations in a relatively short time that would be conducive to harmonious international economic relations." Statement by Donald T. Regan, Secretary of the Treasury, September 23, 1983. "The purpose of the (Proposal) is to permit the States to improve their taxation of multinational corporations." Technical explanation of Treasury Department's Draft Unitary Tax Legislation, p. 1 (July 8, 1985). "I rise . . . to offer a bill that . . . must be offered . . . (to) avoid starting an international conflict over the taxation of multinationals." Remarks of Sen. Wilson (for himself, Sen. Mathias and Sen. Hawkins) on introduction of S. 1974, 99th Cong., 1st Sess., 131 Cong. Rec. S17975 (daily ed. Dec. 18, 1985).

A cornerstone of any viable tax system founded on self-assessment and voluntary compliance is fairness and equity. If a tax system is perceived as unfair or inequitable, taxpayer morale and voluntary compliance is undermined. Shifting burdens of compilation and analysis from the state tax auditor to the taxpayer in an uneven handed manner creates an increased level of perceived unfairness and is therefore counterproductive.

In order, then, to effectively resolve the controversy surrounding worldwide unitary taxation, the Bill should concentrate on this one problem alone. There are a host of other state tax problems which may warrant federal legislation, but which should not be addressed in this Bill. For example, in addition to enhancing state tax compliance by multistate taxpayers through the requirement of a disclosure spreadsheet, federal legislation may be needed in such areas as establishing standards for imposing a duty to collect use taxes, establishing nationwide rules regarding the states' power to levy different types of taxes (e.g., income, gross receipts, capital stock), and enacting uniform procedural rules on items such as filing due dates and statutes of limitations. Instead of tying a measure to promote tax compliance on the domestic level with the limitation of worldwide unitary taxation, it would seem more logical to develop separate, even-handed legislation which deals with the states' concern over tax evasion by multistate taxpayers and, perhaps, the multistate taxpayers' concerns over certain state tax non-uniformity issues.

As a possible approach towards achieving a balanced Bill, i.e., tailoring the disclosure required by taxpayers to fit the problems created by the limitation of worldwide unitary taxation, Congress may wish to consider adopting an election on the federal return where all taxpayers could choose between being taxed on a worldwide combined basis or filing the disclosure spreadsheet. If the taxpayer has no foreign operations, it presumably would elect to file on a worldwide unitary basis, rather than file the disclosure spreadsheet. The taxpayer with foreign operations would have to determine whether it would file on a worldwide basis in states so requesting or file the disclosure spreadsheet. By requiring such an election, the reporting requirements of the Bill would respond to the worldwide unitary taxation issue and avoid the problem of burdening taxpayers which were never directly or substantially affected by this controversy.

Details concerning the mechanics of making the federal election and the consequences of an election to forego worldwide combined reporting in favor of filing the disclosure spreadsheet would have to be determined. We would be pleased to assist the Committee with that endeavor.

B. The Bill Should Not Ignore the Unitary Business Principle.

A state may only tax a multistate controlled group or corporation if the group forms a unitary business, part of which is conducted in the state. The Supreme Court in F. W. Woolworth Co. v. Taxation and Revenue Department, 458 U.S. 354 (1982), reaffirmed the principle that intercorporate ownership is not, of itself, sufficient to create a unitary business. Rather, intercorporate ownership is only one factor that must be considered in determining whether a controlled group forms a unitary business. Other factors to be considered include functional integration, centralization of management, and economies of scale.

State unitary combined reporting stands in marked contrast to the federal consolidated return. Under consolidation principles corporations are generally includible if stock ownership rules are met. To be included in the consolidated return, the corporations need not form a unitary business. In other words, the consolidation and unitary principles are separate and distinct from each other and the rules relating to these two concepts should not be confused.

The unitary business requirement is based in large part on due process concerns. Under the Due Process Clause a state is prohibited from taxing extraterritorial values. Hence, a state simply lacks the power to reach a corporation outside its borders for income tax purposes, unless that corporation is part of a unitary business that is taxable in the state. Congress should be cognizant that if the Bill is read as abandoning the unitary business principle in favor of a state taxation standard based exclusively on ownership, substantial protracted litigation on due process issues may arise. Moreover, it is unlikely that a common ownership principle could withstand scrutiny under the Due Process Clause. In this regard, it should be noted that the Supreme Court of New Hampshire has indicated its belief that a per se ownership rule for determining whether a business organization should be included in a water's-edge combined group would violate federal and state due process requirements. Opinion of the Justices, ___ N.H. ___, ___ A.2d ___, slip. op., (5/1/86), citing Woolworth.

In light of the above, disclosure of information about nonunitary members of a controlled group is neither necessary nor appropriate. A state cannot constitutionally consider this information in taxing in-state corporations. Consequently, such a disclosure infringes on privacy interests without any demonstrated state need.

Not only the Due Process Clause, but also the Commerce Clause is implicated by the proposed legislation on state unitary taxation. Under the Commerce Clause, Congress has the power to regulate interstate and foreign commerce and no state tax can impose an undue burden on such commerce. We commend the Committee on undertaking, through consideration of the Bill, action to alleviate the burden on international commerce created by unitary taxation. We urge Congress to act to eliminate the problems of worldwide unitary taxation through the exercise of its Commerce Clause powers. However, under the Commerce Clause, the federal interest in free trade must be balanced against the states' interest in raising revenues through unitary taxation. Hence, a recurring concern of our testimony is that Congress should carefully direct its action to resolve, as fully as possible, the Commerce Clause problems raised by unitary taxation, while at the same time avoiding unnecessary restrictions on the State's powers to tax. See Garcia v. San Antonio Metropolitan Transit Authority, 105 S.Ct. 1005, 83 L.Ed. 2d 1016 (2/19/85).

C. The Exceptions to Section 7518(a) Permitting Worldwide Unitary Taxation in Some Circumstances Are Inappropriate and Unnecessary.

Section 7518(a), as added to the Internal Revenue Code by the Bill, generally prohibits worldwide unitary taxation and therefore should alleviate many of the international problems created by this method. However, there remain in the Bill certain circumstances in which states may impose taxes on a worldwide unitary basis without the consent of the taxpayer. As a result, the goal of eliminating the problems created by the states' use of worldwide combined reporting is not fully served by this Bill. Under the Bill, a state could impose worldwide unitary reporting on a taxpayer who has not complied with the disclosure requirements of the Bill (Section 6039(a)) or who has not complied with the legal or procedural requirements of the state income tax laws. Thus, the Bill would use worldwide combined reporting as a means of enforcing federal or state laws.

Allowing a state to impose worldwide unitary taxation on a taxpayer for material failure to comply with the legal or procedural requirements of the state's income tax laws raises a question of whether the Bill effectively restricts the use of the worldwide unitary basis. If this provision is used by the states to impose worldwide unitary taxation in any situation in which there is material failure to comply with a state income tax law, the Bill will be an ineffective limitation on the worldwide unitary method, and the international concerns raised currently by this method will continue. If the Bill does not defuse the controversy generated by worldwide combined reporting, its enactment will be futile.

Considering only the language of the Bill, it appears that any material noncompliance with a state's laws would permit it to impose the worldwide unitary method, i.e., the noncompliance need not have any connection with the taxpayer's foreign operations or enforcing water's-edge (as contrasted with worldwide unitary) taxation. For example, an erroneous determination that a subsidiary is not subject to a state's tax jurisdiction because of U.S. Public Law 86-272 may lead a state to an after-the-fact determination that the taxpayer has not materially complied with its laws. Surely it cannot be intended that such a miscalculation should lead to imposition of the burdens of the worldwide unitary basis upon other members of the controlled group. All states have arsenals of penalties available to promote tax compliance. If these state penalties cannot insure compliance with state laws, they should be strengthened directly, rather than indirectly through the use of the worldwide unitary basis.

Furthermore, as discussed above, the definition of "worldwide unitary basis" in Section 7518(c)(2) does not contain any requirement for intercorporate unity beyond intercorporate ownership. Hence, the Bill's definition of the worldwide unitary basis ignores the ultimate issue of whether a controlled group forms a unitary business and thus creates potential due process problems. If the Bill is interpreted as permitting a state to tax the entire income of a controlled group without regard to the unitary business principle whenever Section 7518(a)(1) or (2) is implicated, then this expanded scope of the states' powers to tax foreign affiliated corporations perhaps may create the same international discord currently generated by worldwide unitary taxation.

Generally, if the Bill permits states to impose the mandatory worldwide unitary taxation too frequently, the Bill will have failed to resolve the problems that made the worldwide unitary method an international issue. Accordingly, the circumstances under which the Bill permits states to impose the worldwide unitary method seem to be inappropriate. Worldwide combined reporting is not designed to serve as an enforcement mechanism. Thus, the Bill should directly strengthen legitimate enforcement mechanisms.

D. The Rules on Taxation of Foreign-Source Dividends Should Address More Precisely the Problems of State Taxation of the Earnings of Foreign Subsidiaries.

1. The Taxation of Foreign-Source Dividends Should Be Reconsidered.

The desirability of taxing any portion of foreign-source dividends should be challenged. The treatment of dividends from foreign subsidiaries was "the most significant difference" between the positions of the state and business members of the Task Force on Unitary Taxation. The Final Report of the Worldwide Unitary Taxation Working Group, p. 35 (August 1984). Permitting states to effectively tax 15 percent of foreign dividends, as implied by proposed Section 7518(b)(1), may equalize the taxation of foreign dividends with those of domestic corporations if the state allows a dividends-received deduction comparable to Internal Revenue Code Section 243(a)(1). However, this approach may not be fully satisfactory.

Under the Internal Revenue Code, 100 percent of qualified dividends from members of an affiliated group is eligible for a dividends-received deduction. Thus, dividends from domestic subsidiaries are not subject to federal income tax and in many states are not includible in state taxable income. In this light, any state taxation of foreign-source dividends from subsidiaries may be inconsistent with the third principle developed by the Worldwide Unitary Taxation Working Group to guide state taxation of the income of multinational corporations: "competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." It seems clear that if U.S. multinationals are subject to state tax on 15 percent of their dividends from foreign subsidiaries while purely domestic businesses and foreign multinationals are not taxed on dividends from their subsidiaries, then competitive balance does not exist.

2. Transition Rules Regarding the Taxation of Distributions Should Be Developed.

Consideration should also be given to providing transition rules on the taxation of distributions after the Bill. Depending on the assumptions used about the earnings and profits underlying a particular distribution, the Bill could result in double taxation of foreign earnings. For example, should a distribution be subject to different tax treatment if it is considered to have been made out of earnings and profits accumulated before the enactment of the Bill? If not, undistributed earnings previously subject to state taxation on a worldwide unitary basis may again be subject to tax if distributed in a year in which the state uses water's-edge taxation but includes foreign-source dividends in taxable income.

This issue is related to the limitation on changes in state tax laws regarding foreign-source dividends provided in the last sentence of Section 7518(b): "This subsection shall not be construed to permit State taxation of any dividend not subject to State taxation prior to enactment of this section." The policy behind this provision is unfair if it means that states' laws regarding taxation of foreign-source dividends will be frozen as of the date the Bill is enacted. Specifically, states that imposed tax based on the worldwide unitary method on that date may have no provision regarding the taxation of dividends of unitary foreign subsidiaries (i.e., because the state's tax base has considered the income of unitary foreign subsidiaries rather than their dividends). Under the Bill, these states may be foreclosed from considering any portion of foreign dividends in their tax bases, even though other states may tax these dividends. This illustrates a broader issue raised by this provision: If states that have enacted provisions conforming to Section 7518(b)(1)-(3) before the Bill may tax a portion of foreign-source dividends, what are the problems raised by permitting other states to enact such provisions at a later date? It would seem preferable to permit all states to tax dividends to the same extent, rather than limiting each states' powers to tax those dividends to a different degree depending on the provisions of their laws on the date the Bill is enacted. Finally, it is not clear how the last two sentences of Section 7518(b) interact. For example, may a state tax the dividends of a corporation on the basis that it is the corporation's commercial domicile even if it did not have a law to that effect before the Bill?

3. Section 7518(b) Should Be Extended to "Section 78 Gross Up" And Other Foreign-Related Income Treated As Dividends By the Internal Revenue Code.

Another problem raised by the proposed legislation concerns the scope of the term "foreign-source dividends." The Bill restricts state taxation of foreign-source dividends, but apparently assumes that the concept of "foreign-source dividend" is clear; it is not. For example, the dividend "gross-up" under Section 78 of the Internal Revenue Code has been subjected to state taxation. According to one recent compilation, eight states include the Section 78 gross-up in state taxable income. Panel Publishers, *Multistate Corporate Tax Almanac - 1986 Edition*, pp. 68-70.

Under I.R.C. Section 78, if a domestic corporation elects to take a foreign tax credit for any taxable year, an amount equal to the taxes deemed to be paid by the corporation under I.R.C. Section 902(a) or Section 960(a)(1) for such taxable year is treated for purposes of the federal income tax (other than with respect to the dividends-received deduction of I.R.C. Section 245) as a dividend received by the domestic corporation from the foreign corporation. Although the Court did not address this issue directly, the opinion of the Supreme Court in *F. W. Woolworth Co. v. New Mexico*, 102 S. Ct. 3128, 3139 (1982), does not preclude state taxation of the Section 78 gross-up in a manner consistent with the taxation of the distribution to which it relates.

If the Section 78 gross-up is included in state taxable income because it is not a dividend protected by the Bill, this fictitious income will be taxed at a higher effective rate than that imposed on the underlying dividend. There is no policy justification behind state taxation of the Section 78 gross-up in the first instance, because most states do not provide a foreign tax credit comparable to the federal credit to which the Section 78 gross-up relates. Consequently, there is a definite need to extend Section 7518(b) to cover this income.

In addition to I.R.C. Section 78, there are several provisions of the Internal Revenue Code that impute earnings of a foreign subsidiary to its parent corporation in a manner resembling a dividend. An example is "subpart F income" (I.R.C. Sections 951 to 964). Although subpart F income is not explicitly termed a dividend by the Internal Revenue Code, it is treated as a dividend for most purposes. The problems raised by state taxation of subpart F income are similar to those problems raised by the taxation of dividends from foreign subsidiaries and also are similar to those problems raised by imputed income, *i.e.*, the Section 78 gross-up.

Several other Internal Revenue Code provisions may cause a U.S. parent corporation to recognize ordinary income because of the activities of its foreign subsidiaries without regard to cash distributions. These include gains from certain sales or exchange of stock in certain foreign corporations (I.R.C. Section 1248(a)), the complete liquidation of a foreign subsidiary (Treas. Reg. Section 7.367(b)-5), exchanges of stock pursuant to certain corporate reorganizations (Treas. Reg. Section 7.367(b)-7), and distributions of stock pursuant to certain spin-offs, split-ups, or split-offs (Treas. Reg. Section 7.367(b)-10). In any of these transactions the principles of competitive balance would seem to be best served by exempting the income at issue from any state taxation, or if that is not possible, subjecting these items to no less favorable treatment than that afforded actual cash distributions.

A policy of reducing the state tax burden on actual or deemed foreign-source earnings and profits in an effort to promote competitive equality between foreign-based and U.S. multinationals can only be successful if such "dividends" are treated the same as actual cash distributions. In fact, the policy arguments in favor of mitigating the state tax burden on foreign dividends are perhaps even stronger when the foreign income, unlike the case with cash distributions, does not carry its own wherewithall to pay.

4. Section 7518(b) Should Address the Treatment of Expenses Attributed to Foreign Dividends.

Under I.R.C. Section 265, in computing federal taxable income no deduction is allowed for interest and other expenses related to tax-exempt income. Section 265 does not apply with respect to dividends from foreign subsidiaries inasmuch as they are subject to federal income tax.

Because Section 7518(b) exempts a significant portion of foreign-source dividends from state taxation, it may be necessary to modify the Bill to provide specific rules on the expenses that a state may disallow as deductions because they are attributable to income exempt from state taxation.

E. The Bill's Provisions on Foreign-Source Dividends Should Apply to a Recipient's Legal and Commercial Domiciles.

The Bill permits the jurisdiction of a corporation's legal or commercial domicile to tax its foreign-source dividends without regard to the limitations otherwise imposed by the Bill on state taxation of such income. The policy behind this provision is highly questionable. Presumably the objective of the Bill is to reduce and limit the taxation of foreign-source income including foreign-source dividends. However, this provision allowing the corporation's legal or commercial domicile state to tax the dividends runs afoul of this goal.

Under the worldwide unitary method, intercompany dividends are eliminated, and thus, for a U.S.-based unitary business, unitary taxation focuses on the income of foreign subsidiaries rather than their dividends. Intercompany income is deleted via appropriate intercompany eliminations. The income of this worldwide unitary business is then apportioned based on the relative presence of certain factors (generally payroll, property and sales) in the state compared to those factors worldwide. Consider how this treatment under worldwide unitary taxation contrasts with the Bill's proposal to permit taxation of foreign dividends by the recipient's legal or commercial domicile. Under the Bill, dividends of a foreign subsidiary would be included in the domicile state's tax base; however, they would not be apportioned by reference to the relative amount of the taxpayer's income-producing activities within the state and worldwide. Rather, the entire foreign-source dividend could be taxed by a state merely because it was the corporation's legal or commercial domicile. Thus, under the Bill a corporation could face a higher effective state tax on its foreign-source dividends by its legal or commercial domicile, which need not apportion them, than it would under the worldwide unitary method where the foreign subsidiary's income is apportioned. Such a result clearly flies in the face of the policy objectives of the Bill.

In addition, the Bill raises the potential for duplicative taxation. For example, if state A taxes foreign-source dividends of corporations that have a state A legal domicile and state B taxes foreign-source dividends of corporations with a state B commercial domicile, a corporation incorporated in state A with a state B commercial domicile will pay tax on 100 percent of its foreign dividends in both states. By exchanging its legal and commercial domiciles, the corporation could escape all state taxation on its foreign dividends. A federal law concerning state taxation should foster greater uniformity of state laws rather than creating the potential for greater nonuniformity and double taxation.

F. The Bill Should Not Exempt Certain Foreign Corporations From State Income Taxation.

While Section 6039A may be overly broad in reaching wholly domestic taxpayers, the same provision may also adversely affect the states' jurisdiction to tax. Under the Bill, certain foreign corporations with U.S. presence that satisfies an "80/20" taxable presence test and with less than $10 million in U.S. assets, sales, and payroll, may not be included in the water's-edge group. While this exclusion is desirable in restricting worldwide unitary taxation, if the bill is read as prohibiting any state taxation of foreign corporations other than those specified in Section 7518(c)(2)(D), a corporation may have a substantial presence in the state (e.g., nearly $10 million in compensation, sales, and property) and still escape state taxation. The Bill should clearly specify that states are entitled to tax a corporation's U.S. source income on a separate return basis where that corporation has taxable activities in the state because of its own activities, even though such corporation is excluded from any water's-edge unitary group.

G. Administrative Costs May Not Warrant the Benefits Sought by the Bill.

As accountants to multinational corporations, we can attest that the administrative costs of preparing the information return required by Section 6039A ("the disclosure spreadsheet") and its supporting schedules will be substantial. The wisdom of enacting such disclosure requirements is questionnable in light of the fact that most of the information contained in the disclosure spreadsheet would be available to the states from other sources. Moreover, it is questionable whether the states even have the resources to adequately analyze spreadsheet information and thereby benefit from their preparation. Whatever criteria are used to evaluate the merits of the Bill, it is unfair and counterproductive from a compliance viewpoint to enact a law with administrative costs that exceed its benefits.

Perhaps more fundamentally, however, the Bill assumes noncompliance and evasion. Why else would multistate taxpayers have to file a cornucopia of tax returns, then account and reconcile in a costly, time-consuming manner the information already accessible to the state? Taxpayers that were never subject to nor materially affected by worldwide combined reporting may be particularly hard hit by the Bill. Unlike multinational taxpayers, these taxpayers will not receive any benefits from the Bill's elimination of worldwide combined reporting and restrictions on state taxation of foreign-source dividends.

In this regard, it may be desirable to provide additional exemptions from the Bill's filing requirements for certain businesses. For example, rather than requiring filing in years in which the Act's $10 million or $250 million tests are satisfied, it may be desirable to limit the disclosures to companies that consistently satisfy these tests, e.g., through the use of three-year moving averages rather than an annual determination. This approach would better limit compliance costs to those businesses with a significant continuing foreign presence.

H. The Compliance Burdens of the Bill Should Be Considered.

The Bill is designed to answer concerns voiced by multinational corporations and our foreign trading partners about the states' use of worldwide unitary taxation. Their concern was not only that worldwide reporting leads to extraterritorial taxation, but also that worldwide reporting imposes excessive administrative costs and disclosure burdens. The Bill does little to reduce these compliance costs and problems.

For example, Section 6039A(b) imposes a heavy administrative burden on the reporting corporation of a controlled group that includes a foreign corporation that is not required to file a federal income tax return. In this very typical situation, the reporting corporation must supply much of the information about the foreign corporation that would be presented on a federal income tax return, i.e., the reporting corporation would be required to prepare and present some of the foreign corporation's financial data in U.S. dollar amounts and methods. Imposing additional costs, as well as exposure to increased penalties, on U.S. corporations with foreign-based affiliated corporations violates the principle of competitive balance between multinational and purely domestic businesses. These administrative burdens may make compliance with the Bill as burdensome as the compliance with worldwide combined reporting.

A more fundamental problem is the failure to analyze the costs of preparing the disclosure spreadsheet. There is no clear data on the cost of compliance with this bill; only speculation based on the illustrative spreadsheet and its schedules contained in the working group report. We would suggest that it is impossible to make a meaningful cost-benefit analysis of the Bill when information on the most objectively determinable cost -- the cost of compliance -- is not available.

I. Federal Filing Should Not Constitute an Original State Filing for Purposes of Penalties.

In addition to federal penalties, the Bill would permit states to treat a failure to substantially comply on a timely basis with federal law as a violation of state law. There are serious problems of equity and fairness in treating a filing of the disclosure spreadsheet with the federal government as an original filing with the states, thereby exposing taxpayers to state penalties. That state penalties should adhere to a failure to substantially comply with federal information return requirements is novel to the Internal Revenue Code. Furthermore, an affected taxpayer cannot know from the face of the federal statute the sanctions it faces for incomplete compliance, or late but full compliance, with federal law. As the Bill is currently worded, the extent of penalties for noncompliance can only be determined by reference to state laws, and thus turns in large part on the states in which the taxpayer does business.

The Bill places no restrictions on the maximum penalty that a state may impose for violations of the Bill, nor does it require states to follow the procedural safeguards (i.e., notice requirements) imposed upon the Federal government in enacting penalties for violations of the Bill's filing requirements. Thus, these state penalties for noncompliance with the Bill may be substantial. Also, the Bill's penalties for noncompliance are dependent upon the state or states in which the taxpayer is present, as well as dependent upon the willingness of these states to commit their enforcement budgets to enforcing federal law, possibly at the cost of diverting resources from enforcing other state laws.

In addition, it is difficult to rationalize as a threshold matter why noncompliance with a federal information reporting requirement should support a state penalty. If federal sanctions for noncompliance cannot ensure compliance with the Bill, it certainly seems more appropriate to strengthen federal sanctions than to rely on additional state penalties.

For all the problems raised by the provision for state penalties, can their contribution to enhancing compliance be anticipated to be anything but minimal? It is unreasonable to expect the threat of state penalties to enhance compliance with federal law when the non-complying taxpayer may already be subject to a federal penalty of up to $25,000. Moreover, this problem of concurrent federal-state penalties is exacerbated when a reporting corporation reasonably concludes that it has no responsibilities under the Bill. Yet, the Bill fails to provide a reasonable cause exception to the federal penalty of Section 6039A(e) and does not mandate that state penalties provide such an exception.

Finally, there are issues of uniformity in the administration of the Bill. The federal penalty in Section 6039A(e)(1) is imposed for failure "to comply substantially" with Section 6039A(a) by the due date set out in the later subsection. Thus, one potential defense to the federal penalty is that substantial compliance has occurred. As currently proposed, Section 6039A(d) does not require a state to abate any penalty for substantial compliance. Furthermore, it is unclear whether the Bill authorizes state courts to make a finding of noncompliance without regard to any federal determination on this issue. Thus, the Bill raises the possibility of two undesirable consequences: that a federal court and a state court may reach inconsistent determinations on whether a taxpayer is in substantial compliance with federal law as applied to the same facts, and that two state courts similarly may reach inconsistent conclusions. Consequently, if state sanctions to promote compliance with the Bill are not dropped, then, at the very least, their use should be limited to circumstances in which there is a prior federal penalty imposed with respect to the spreadsheet in question.

J. Federal Review of Controversies Arising Under the Bill is Necessary.

A major flaw in the Bill is its failure to provide uniform administrative reviews and/or judicial remedies for taxpayers. Consideration should be given to granting the Secretary of the Treasury or his delegate and/or the federal district courts jurisdiction over controversies arising under the Bill. At the judicial level, there is precedent for such action. In this regard, it should be noted that federal law prohibits certain state tax discrimination against rail transportation property. The law provides in part:

> Notwithstanding Section 1341 of title 28 and without regard to the amount in controversy or citizenship of the parties, a district court of the United States has jurisdiction, concurrent with other jurisdiction of courts of the United States and the States, to prevent [specified acts of tax discrimination against rail transportation property]. 49 U.S.C. §11503(c).

Under federal law, U.S. district courts are similarly granted jurisdiction with respect to tax discrimination against motor carrier transportation property. 49 U.S.C. §11503a(c). If the Secretary or his delegate and the federal courts have jurisdiction to consider controversies arising under the Bill, it may be hoped that uniform interpretations will develop. Where this type of review has not been provided, as with U.S. Public Law 86-272, state decisions have been contradictory and no uniform interpretation of federal statutory limitations on state taxation have emerged. See P. M. Tatarowicz, "State Judicial and Administrative Interpretations of U.S. Public Law 86-272," 38 Tax Lawyer 293 (1985).

K. The Bill Should Provide Stronger Confidentiality Safeguards.

By providing some penalties for illegal disclosure the Bill tacitly recognizes that considerable harm could ensue if a reporting corporation's spreadsheet were improperly disclosed. From an examination of the penalty provisions it appears that Congress may have drastically underestimated the extent of the damage that would be wrought through the improper disclosure of information. We feel that the Bill does not contain adequate safeguards, and that I.R.C Sections 7231 and 7213, imposing penalties on state tax officials for illegal disclosure, are unsatisfactory in this regard.

Section 6039A requires disclosure of competitively sensitive information. For example, spreadsheet information would permit a competitor to gauge the relative profitability of a taxpayer's operations in different states. Furthermore, because of this state-by-state breakdown in a single document, the disclosure spreadsheet may contain a greater potential for competitive harm than any single state's income tax return. We are concerned that access to the disclosure spreadsheet be carefully controlled and accordingly believe that greater confidentiality safeguards are needed.

Furthermore, the need for sharing of Section 6039A information directly between states is far from clear. Rarely, if ever, will the information contained in the Section 6039A disclosure itself lead to the assertion of a deficiency; the spreadsheet disclosures appear to be intended principally to aid in the selection of taxpayers for audits. These audits in turn may lead to the discovery of deficiencies. It is difficult to comprehend how an inability to receive Section 6039A information from another state could interfere with an effective state tax audit. In short, if a state wants information available in the disclosure spreadsheet, it should be required to obtain it from Treasury, rather than from another state.

L. The Rules Regarding the Taxation of 80/20 Companies Should Be Re-examined.

1. The Bill should not make a distinction between large and small 80/20 companies.

Under Section 7518(c)(4) of the Bill domestic corporations with less than 20 percent of certain defined factors assignable to locations in the United States are deemed to be foreign corporations excludable from a water's-edge group. However, whether such a corporation is in fact excluded from the water's-edge groups depends upon its size. An 80/20 company is included in a water's-edge group if it has $10,000,000 or more of certain defined compensation, sales, purchases or property assignable to one or more locations in the United States. Thus, in tailoring the water's-edge group, the Bill distinguishes between large and small 80/20 companies.

There is no policy reason for this distinction between large and small 80/20 companies. Perhaps the distinction which taxes some 80/20 companies as members of the water's-edge group while exempting others is meant as a compromise position. Nevertheless, this approach is severely flawed even as a compromise position, because the dollar limits determining whether an 80/20 corporation will be included within the water's-edge group may be easily avoided by some taxpayers. To avoid being included within a water's-edge group, an 80/20 corporation may be encouraged by the Bill to simply reduce its operations in the United States. As the Bill is written currently, this could easily be accomplished: for example, by separately incorporating the 80/20 corporation's U.S. operations. Assuming reasonable, cost-effective taxing mechanisms could be enacted to temper such avoidance plans, companies could still avoid including their foreign operations in the water's-edge group by simply disposing of their 80/20 corporation's U.S. operations which exceed the Section 7518(c)(4) limits. Such corporate actions could be more detrimental for U.S. and state economies than simply allowing such corporations to exclude their foreign operations from the water's-edge group. For instance, an 80/20 corporation might find it less expensive to replace its U.S. jobs with jobs outside the U.S. or change its purchasing habits by buying from non-U.S. companies rather than U.S. companies than to pay state taxes based on the results of its 80/20 companies.

To provide parity with our proposal that the Bill should not exempt certain foreign corporations from state income taxation (see F at p. 21 above) the Bill should clearly specify that states are entitled to tax an 80/20 corporation's U.S.-source income on a separate return basis where that corporation has taxable activities in the state because of its own activities, even though such a corporation is excluded from any water's-edge unitary group.

2. The State Tax Definition of an 80/20 Company Should Conform to Its Federal Counterpart.

The exclusion or inclusion of a corporation with, in part, 20 percent or less of certain defined factors assignable to locations in the U.S. from the worldwide unitary basis definition is also troublesome. Although the issue of so-called "80/20" corporations received much attention in the deliberation of the Working Group and Task Force, there is no apparent policy reason for using different definitions of 80/20 companies for federal and state taxation, particularly if the business representatives on the Working Group were correct in asserting that the payroll and property test for 80/20 status under state law and the federal income sourcing rules generally classify corporations consistently.

M. Need For Disclosure Spreadsheet Federal Legislation.

It must be considered whether federal legislation is needed to provide the proposed spreadsheet's information to the states. Even assuming that a disclosure spreadsheet would be useful to states in auditing multinational businesses, does it follow that federal legislation is needed for states to obtain this information? At least with respect to affiliated corporations that form a unitary business, there appears to be no federal constitutional barrier to states requiring disclosure of information contained in the spreadsheet; this is a logical corollary to the Container decision.

In fact, Idaho has already passed legislation enabling its tax commission to require certain taxpayers making a water's-edge election to file a disclosure spreadsheet if various conditions are met (e.g., the United States fails to require these taxpayers to file a spreadsheet with the Internal Revenue Service). Proposed legislation drafted by a North Dakota Interim Taxation Committee would similarly require the same disclosures if enacted.

In addition, various other states have taken steps, both legislatively and administratively, towards enacting their own spreadsheet requirements. For example, on August 26, 1986, the California Senate and Assembly approved a compromise unitary tax reform bill which, in addition to offering electing taxpayers the option to file on a water's-edge basis for 10-year periods, would require the filing of a domestic disclosure spreadsheet. The New Mexico Department of Revenue has likewise considered mandating disclosures similar to those called for in the Bill. New Mexico's taxing authorities believe that under the state's general administrative powers specific state legislative authorization is not required to mandate this sort of disclosure. Moreover, it is interesting to note that the Working Group included as a "common element" the existing fact that taxpayers must make available to state tax auditors "all state corporate tax returns filed by each corporation in each state." Report at p. 33. This information would provide much of the detail provided in the spreadsheet. Care should be taken that states are not foreclosed from requiring information they have a legtimate interest in obtaining by what might be viewed as federal preemptive legislation.

If states can require the same information without federal intervention, federal legislation may be unnecessary. Historically, both states and taxpayers have opposed federal legislation addressing state tax problems where proponents of the legislation argued federal action was the only effective way of addressing the problem. Here, where no clear need for federal action exists, perhaps action may best be left to states that feel a need for the disclosures, for example, through uniform legislation or through a multistate compact.

II. Technical Problems.

The following comments highlight certain technical problems we feel exist in the Bill as currently proposed. While some of these issues have not been alluded to in our general concerns discussed above, many can be viewed as logical, related extensions of those concerns. For example, we elaborate below on the problems which result from the failure of the Bill to limit the required disclosures to unitary businesses. Other areas discussed below related to our general concerns include the scope of the Bill's penalty provisions, its application to purely multistate businesses, and the centralized control function we feel the Treasury Department should maintain.

The comments below are organized in the order the Bill presents proposed amendments to the Internal Revenue Code: Section 7518, Section 6039A, amendments to Section 6103, and effective date.

A. Section 7518.

Although many of our concerns with Section 7518 are detailed in our "General Concerns" discussion above, additional comments are presented below.

1. The Bill Should Clearly Indicate That Its Definition of State Includes the District of Columbia and That Section 7518 Applies to State Subdivisions.

The Bill does not define the scope of "State." Such a definition is desirable in order to avoid uncertainties and make the Bill fully effective.

a. The District of Columbia Should Be Treated as a State for All Provisions of the Bill.

The Internal Revenue Code definition of state, I.R.C. Section 7701(a)(10), does not treat the District of Columbia as a state for all purposes but rather "where such construction is necessary to carry out the provisions of this title." The absence of guidance in U.S. Public Law 86-272 on whether the District of Columbia is considered a state has led to litigation over this issue. Jantzen, Inc. v. District of Columbia, 385 A.2d 29 (D.C. 1978). The Bill should specify that the District of Columbia is to be treated as a state, if this is the intent of Congress.

b. State Subdivisions Should Be Subject to Section 7518.

The arguments for restricting the use of worldwide unitary reporting and taxation of foreign-source dividends apply with equal strength to political subdivisions of states, and Section 7518 should apply to municipal taxes and other taxes of political subdivisions of states. However, the burden on taxpayers to compile and disclose information concerning local taxes probably outweighs any benefit which the state subdivision could derive from the information. As a result, the spreadsheet should not be disclosed below the state level. Therefore, Section 7518, but not Section 6039A, should apply to both states and their political subdivisions.

2. States Should Not Be Required to Request Information On Related-Party Transactions From Foreign Governments.

Section 7518(a)(2) would permit a state to impose worldwide unitary taxation where neither the taxpayer nor the government of the relevant foreign country provides to the state, within a reasonable time after proper request, material information relating to the determination of income on transactions between members of a water's-edge group and foreign members of the same controlled group. It is difficult to see how the requirement of Section 7518(a)(2) that states attempt to obtain information from foreign governments substantially enhances the states' enforcement powers or necessarily protects the taxpayer. There appears no strong need for the state to approach a foreign government for this information. By definition the transactions to which the Section 7518(a)(2) applies are between members of the same controlled group. The state should be able to obtain the information on the foreign member of the controlled group from a member of the controlled group within the water's edge. Moreover, it is likely that the member of the controlled group within the water's edge will have access to information regarding transactions between members of a water's-edge group and foreign members of the same controlled group. These transactions generally will have federal tax implications, so that taxpayers must be able to produce adequate records in order to pass I.R.S. scrutiny, such as possible challenges under I.R.C. Section 482. Finally, it is difficult to conceive of situations in which information will be available from the foreign government that is not also available from members of the controlled group, because in most cases the foreign government's information will be derived from reports filed by the corporation.

In view of these uncertainties, requiring inquiry of foreign governments by state tax administrators gives little additional assistance to the states or protection to taxpayers, and in fact may increase delays and inefficiencies and costs of state tax administration. For example, must a state show that it has made a "proper request" to a foreign government, regardless of how futile it may be, when the state has failed to obtain adequate information on transactions with affiliated taxpayers from intransigent taxpayers?

3. Provision Regarding the Election to Be Taxed on the Worldwide Unitary Basis Should Be Clarified.

Section 7518(a) does not preclude any state from permitting a taxpayer to be taxed on a worldwide unitary basis pursuant to an unconditional election by such taxpayer. The scope of this provision is unclear, especially in determining what is meant by "an unconditional election." Contrary to what might be expected, the "Technical Explanation of Unitary Tax Legislation" indicates that the absence of a condition in the election relates primarily to the absence of any substantial condition on the part of the state:

> Thus, the imposition of significant fees for the privilege of making an election or investment restrictions on the right to make the election would not be permitted. Reasonable restrictions placed on the taxpayer's ability to shift from one method of computing its tax liability to another method from year to year would not violate this rule. (p.2).

Section 7518(a) should be modified to reflect these standards.

4. The Definition of "Tax Haven" Corporations Should Be Narrowed.

Section 7518(c)(3)(C) defines a foreign corporation that may be included in a water's edge group to include a foreign corporation that "is not subject to substantial foreign tax on its net income." There are several significant problems with this attempt to include all corporations with activities in "tax haven" jurisdictions in the water's-edge group.

Initially, clearer guidance is needed on the standards Congress intends to be used in identifying tax haven jurisdictions and the taxes that are to be considered as levied, at least effectively, on net income. State representatives of the Working Group suggested a definition of a tax haven as "any country which either does not impose an income tax or whose income tax rate is less than 90 percent of the U.S. tax rate;" business representatives advanced a similar definition using a 65 percent standard. Notwithstanding this apparent consensus on using federal rates to identify tax havens, defining "tax havens" via the use of statutory marginal income tax rates is inappropriate. This is illustrated, for example, when it is realized that the U.S. could be a tax haven country if H.R. 3838 were enacted in comparison to current statutory rates using the definition of a tax haven proposed by state representatives of the Working Group. Moreover, under a quantitative standard of this sort, a country may be a tax haven in one year and not in another year even though there is no change in its tax law, if there is a change in U.S. rates.

More fundamentally, tying the definition of tax havens to the imposition of a net income tax presents significant problems. As recognized by Section 903 of the Internal Revenue Code and its applicable Regulations, many foreign nations do not impose income taxes but impose other significant taxes in lieu of a tax on income. Such taxes may be based on gross income, gross receipts or sales, or the number of units produced or exported. Particularly, in the case of specialized industries, taxes may not be based on net income. For instance, insurance companies may be taxed on gross receipts, rather than net income. Moreover, other nations, notably those with significant natural resources, may not impose taxes at all but may impose license or concession fees to the same effect.

Although the issues for both nonincome taxes and fees bear a superficial resemblance to issues under the foreign tax credit, the objective under Section 7518 is very different: to identify foreign countries that permit themselves to be used as tax havens to activities distorting state taxable income. Because many foreign countries do not impose net income taxes but impose levies that discourage income-shifting activities, a narrower definition of "tax haven" is necessary.

Finally, the inclusion in the water's-edge group of all corporations active in a tax haven (regardless of the scope of that term's definition) is based on the assumption that in all cases these corporations are used in tax avoidance. In many cases, however, a unitary group may have activities in tax havens for bona fide business reasons, e.g., access to natural resources. Because a blanket rule may tax bona fide foreign operations, an exception for such operating companies should be provided. If necessary to make this rule workable, the taxpayer could be required to carry the burden of proof that tax avoidance is not a principal purpose of its "tax haven" activities or certain "safe harbors" could be established.

B. Section 6039A.

1. More Detail Is Needed on the Disclosures Contemplated By the Bill.

Much of the disclosure contemplated in the Working Group's recommendations with respect to increased information disclosure is not included in Section 6039A. For example, one such item is a reconciliation of the apportionment factor used by the taxpayer under state law and the taxpayer's apportionment factor for each state computed under the Uniform Division of Income for Tax Purposes Bill (UDITPA). If these disclosures will be required by regulations (i.e., as part of "such other information as the Secretary may by regulation prescribe"), they should be specifically enumerated in Section 6039A(a). Also, detailed guidance or exceptions from a reconciliation requirement should be provided for industries whose businesses do not fit within the parameters of UDITPA, e.g., non-manufacturing or non-mercantile entities.

Furthermore, concrete guidance is needed on the detail contemplated by Section 6039A. Although specific problems are addressed below, at this point it is sufficient to note that the disclosure of "income subject to tax" in each state could be satisfied by disclosures ranging from a single summary number for each state to a transaction-by-transaction breakdown. Clarification of the level of detail contemplated is necessary to make a cost-benefit evaluation of the Bill.

Section 6039A(a) specifies certain disclosures which are complex and far removed from any attempt at tax simplification. Consider each item of information to be required:

a. The reporting corporation's income tax liability to each state in which it is liable. For many corporations there will be a threshold issue with respect to state tax jurisdiction ("nexus") determinations. Evaluating whether an entity is subject to a given state's tax jurisdiction requires a detailed subjective analysis of the state's nexus requirements and a consideration of federal and constitutional law. This is particularly true of service industries and other taxpayers that do not deal in tangible personal property. As noted earlier, a taxpayer's determination that it does not have nexus, which already may subject a taxpayer to state penalties if erroneous, will carry new risks of federal and state penalties under the Bill.

Second, phrasing the requirement in terms of an "income tax liability" is unduly vague. The Bill does not address whether a corporation should report when it is taxed on an alternate basis (e.g., capital stock or gross receipts) rather than upon its income. In other words, does a requirement exist when the state imposes an income tax only if the corporation's income-based liability exceeds its liability computed using another base? Furthermore, the Bill does not address the reporting responsibilities of any specialized industry that a state may tax on a basis other than an income tax that the state imposes on most corporations (such as where a state taxes insurance companies on gross premiums).

b. Income subject to tax. There is a need for specific guidance on the level of detail Congress intends to be disclosed as "income subject to tax." This term is not self-defining, and could be satisfied by disclosures ranging from a single number for taxable income to a detailed breakdown of the components of income including revenues, deductions, and nonbusiness income allocated to specific states.

c. The method of computation and allocation. As with the enormous range in detail which could be required with regard to "income subject to tax," the disclosure of "allocation" information called for by the Bill is troublesome. Furthermore, "allocation" is a term of art employed by states that have adopted UDITPA which refers to the method of assigning nonbusiness income to a single tax jurisdiction. Accordingly, the use of the word "allocation" in Section 6039A(a) should be stricken in favor of more precise terminology or defined appropriately to include apportionment data (formulary apportionment of business income).

Again, as in the definition of "income subject to tax," the level of detail contemplated by the "method of calculation" used by a taxpayer in "allocating its income" is not clear. For example, it could contemplate a single apportionment number, a breakdown by factor (e.g., disclosure of a property factor) or a high level of detail for each factor (e.g., disclosure of beginning and ending property costs and annual rentals paid by the taxpayer). Finally, as noted above, there may be need for additional guidance for industries that historically have not followed the typical UDITPA apportionment approaches, such as financial corporations, transportation, and telecommunication companies.

d. Disclosure of data based on stock ownership. Section 6039A(a) calls for disclosure of any corporation in which the reporting corporation or a corporation owning at least 50 percent of the reporting corporation's voting stock owns, directly or indirectly, more than 20 percent of the combined voting power of all classes of stock entitled to vote. These ownership provisions raise several problems.

First, by imposing the ownership disclosure requirement with respect to "50% or more" owners, rather than on owners of "more than 50%" of a corporation's stock, the Bill potentially requires multiple filings where a corporation has two 50-percent owners, e.g., if the reporting corporation is an equal joint venture of two foreign corporations.

Second, the Bill makes no provision for attribution rules expanding upon its "direct or indirect" language. For instance, the Bill does not specify whether partnerships, joint ventures, or trusts will be considered in evaluating ownership arrangements among related corporations.

The provision of attribution rules would be beneficial for both taxpayers and states. For example, taxpayers may well argue that the same conclusions that preclude states from taxing foreign-source distributions should preclude states from taxing distributions from foreign partnerships and joint ventures. Conversely states may be concerned that a business may avoid the definitions of controlled and affiliated groups by using joint ventures, partnerships and trusts, instead of incorporated subsidiaries.

The lack of attribution rules could also frustrate legislative intent and result in nonuniformity among the states. For example, a New York-based shareholder lacking federal guidance on ownership attribution may adopt the direct-indirect definition of its home state. New York applies only a very limited attribution, and does not look beyond first-tier subsidiaries in imputing stockholder status. See e.g., Hooker Chemical & Plastic Corp., TSB-H-81(37)C (NY Tax Com'n. 1981). Other states may adopt more expansive ownership attribution rules. Because the direct-indirect language recurs in the Bill, it is imperative that the stock attribution rules governing Section 6039A, if any, be specified clearly.

Finally, there appears no strong reason to extend the disclosure requirements to include investments of more than 20 percent. It is unlikely that any substantial degree of non-compliance with state income tax laws could be attributed to investments of only a little more than 20 percent. Hence the burden of such disclosure requirements on the taxpayers seems to outweigh any conceivable gain in state tax compliance.

e. Other data -- Section 6039A allows for such other information as the Secretary may by regulation prescribe. Because this historically has been the exclusive preserve of the states, it would be preferable for the taxpayers and the states to know before enactment the precise scope of this grant of authority.

2. The Definition of Reporting Corporation Should Be Clarified And Conformed More Closely to Common Principles of State Taxation.

Section 6039A(c) states that a reporting corporation is one which, among other things, is required to file a federal income tax return. This, however, completely ignores state nexus standards. Thus, a corporation lacking nexus with any income taxing state but filing a federal income tax return (e.g., a corporation whose domestic activities are conducted entirely in nonincome taxing states) must prepare a Section 6039A return that will not be used by any state.

In addition, the definition of reporting corporation is puzzling in using standards resembling those employed by the states in apportioning income, but departing from the general approach taken by the states in important particulars. For example, although UDITPA uses payroll, property and sales concepts, these concepts apparently are defined differently in UDITPA and in the Bill. For example, most states consider leased property in determining a taxpayer's property factor; the Bill makes no reference to leased property. The compensation and receipts tests raise similar difficulties. For example, most states' sales factors consider all business income, not just income from sales of tangible personal property. Hence "gross receipts" may be a better term than sales." By using the term "sales" the Bill leaves no guidance as to the Bill's application for taxpayers that are not engaged in sales of property, such as banks and service companies.

Consideration should be given to bringing the Bill into closer conformity with UDITPA. Failure to conform the Bill to the general state approaches to these issues will create problems with tracking different computations for federal and state law where the same items are being collected to determine state tax liabilities. We recognized that adopting UDITPA definitions would not eliminate disparities for a taxpayer operating in the approximately two dozen states that have not substantially adopted UDITPA. Nevertheless, closer conformity to the UDITPA standards may limit the compliance problems of taxpayers. As a collateral benefit, it may be hoped that the adoption of standards styled on UDITPA would provide states with a greater incentive to move toward a uniform approach in these issues, and thus through federal action move toward a system of greater certainty for both taxpayers and the states.

3. Authority to Promulgate Regulations Clarifying Computations in Applying the Tests for Reporting Corporations Should Be Granted to the Secretary of the Treasury.

Under Section 6039A(c)(1)(A), the Secretary has the authority to increase the dollar thresholds in determining whether a corporation is a reporting corporation and is explicitly granted authority to provide regulations governing the "allocation" of compensation payments, property, or sales, to or among foreign countries.

Although the Secretary is given explicit authority to specify how the factors in Section 6039A(c)(1)(A)(i) to (iii) are to be "allocated," no explicit grant is given permitting the Secretary to specify the content of these factors. These factors are not self-defining. For example, it is not clear if intangible assets are to be considered in determining the amount of a taxpayer's property. States typically exclude intangibles in determining their property factors. Similarly, state sales factors typically consider all the business income of the taxpayer, whether generated from sales of property, rents, dividends, interest, licenses of intangible property, etc. The Bill, in contrast, apparently only considers sales of property in its determination of a taxpayer's sales. In addition, states frequently modify the definitions of the components of their apportionment factors for industries that are not involved in producing or selling tangible personal property.

The Secretary should be given the authority to specify what is to be considered in computing each factor so that these and similar issues can be addressed. The primary objective of this grant of authority is, of course, to bring certainty to the determination of whether a corporation is a reporting corporation. As discussed above, it may be hoped that a secondary benefit of federal rules in this area would be greater uniformity in the apportionment of the income of interstate businesses, should states follow the definitions adopted by Treasury. While it is unlikely that a single set of rules could be developed that would be fully satisfactory in every circumstance, any movement toward greater uniformity would be beneficial both to multistate taxpayers and to the states.

4. The Definitions of Affiliated And Controlled Groups Should Be Clarified to Direct Their Scope Toward Unitary Businesses.

   The definitions of affiliated and controlled groups illustrate the undue breadth of the Bill because these definitions include corporate members regardless of whether they form a unitary business. Curiously, however, the definition of a controlled group excludes, by incorporating I.R.C. Section 267(f)(1), certain types of potentially unitary corporations without evident policy basis, such as certain insurance companies (I.R.C. Section 1563(a)(4)). These definitions should be evaluated to determine whether they indeed specify the corporations which Congress wants to be affected by the Bill.

5. There Is a Need For a Reasonable Cause Exception to the Various Penalties That May Be Imposed Under the Bill.

   As stated in the foregoing discussion of general concerns, taxpayers are subject to federal as well as state penalties under the Bill, notwithstanding good faith compliance efforts. Although, as we have indicated above, we believe that multiple federal-state penalties are unnecessary, at the very least a reasonable cause exception to the Section 6039A(e) penalty and any state penalties is needed. Much of the information required under Section 6039A calls for subjective judgments, such as whether the taxpayer is exempt from state tax jurisdiction under the Due Process Clause or U.S. Public Law 86-272. Because the Bill contains areas in which reasonable minds can differ, a reasonable cause exception for failure to file or make all required disclosures is needed. In this regard, the fact that the I.R.C. Section 6038 penalty does not have a reasonable cause exception is not persuasive because the information required by Section 6038 is more objective than the judgments required under Section 6039A.

   Furthermore, focusing on the federal penalties, the Bill is unclear on whether the Section 6039A(e) penalty stands alone or other penalties (notably I.R.C. Section 7203 on willful failure to file and I.R.C. Section 7206 on fraudulent statements) also apply. Moreover, if the Section 6039A(e) penalty is the only applicable sanction under the Bill, the maximum dollar penalty of $25,000 may be too low, because this amount might be less than the administrative costs of complying with Section 6039A. This problem is compounded by the extended period for assessment. In addition to the availability of extensions of time to file, there is a 90-day post-notice requirement, and a 24-month penalty accrual period. As a result, a taxpayer will not face the maximum penalty until at least three years after the taxable year end. Finally, we reiterate the concerns expressed above on allowing the states to impose income tax on any taxpayer on a worldwide unitary basis if the taxpayer materially fails to comply with the requirements of Section 6039A. If the Section 6039A(e) penalties are insufficient to promote taxpayer compliance, this subsection should be strengthened to promote compliance through federal enforcement rather than requiring the states to bear the costs and burdens of enforcement.

C. Section 6103.

1. Disclosures Should Only Be Made to Agencies Enforcing a State's Income Tax Laws.

   Section 4 of the Bill amends Section 6103 of the Internal Revenue Code, regarding the confidentiality and disclosure of returns and return information. Subsection (1) effectively permits disclosure of tax return information to any state agency to the extent necessary in the administration of its tax laws. This broad sweep goes well beyond the Working Group's recommendation, which provided federal assistance to promote full "disclosure to states to assist them with enforcement of a water's-edge unitary tax." Report at p. 9.

Under the Bill the disclosure may be made to "any State tax agency" for use in administering "the tax laws of a State." This provision permits disclosure to agencies that have no interest in administering the state's income tax laws as defined in Section 7518(c)(1). As previously indicated, the disclosures called for under Section 6039A are sufficiently sensitive that they must be safeguarded from unauthorized disclosure. Accordingly, Section 6103(d)(1) should be modified to provide: "For purposes of disclosing the return described in Section 6039A, a state tax agency shall mean the state tax agency or agencies, as defined in subparagraph (d)(4)(B) of this section, charged with the administration of the corporate income tax (as defined in Section 6039A(c)(1)) laws of the State."

2. The Effects of Subsequent Events on The Spreadsheet Should Be Specified.

The Bill does not address the effects of subsequent adjustments on the sufficiency of a taxpayer's spreadsheet. For example, do state tax adjustments resulting from state tax examinations, nexus determinations, or amended state returns, require an amended disclosure spreadsheet? If not, will states fully benefit from the Section 6039A reporting/enforcement mechanism? Conversely, is it fair to place a federal compliance burden on taxpayers based upon the enforcement actions of each state's tax administrators?

3. Rules Regarding Disclosure to State Tax Officials Should Be Clarified.

a. The Threat of Impairment of State Investigations Should Be Sufficient to Restrict Disclosure Under the Bill.

Section 6103(d)(2)(A) restricts disclosures that might impair a civil or a criminal tax investigation. It is unclear, however, whether this section applies to state tax investigations or is limited to Federal investigations. Disclosure should be restricted where it could reveal a federal or a state's confidential informant or seriously impair a state's civil or criminal tax investigation. This protection may only be effective if disclosure is centralized in the Treasury and inter-state disclosure is limited.

b. Disclosures to State Audit Agencies May Be Unnecessary, and at a Minimum Should Be Restricted.

While Section 6103(d)(2) restricts disclosure, Section 6103(d)(3) allows disclosure to a state audit agency for purposes of a review of the state tax agency. No policy has been articulated on the need for this provision. It is not clear how disclosure of the details of individual spreadsheets would aid in assessing tax agency performance, and particularly whether this broadened disclosure outweighs the privacy concerns it raises.

Furthermore, Section 6103(d)(4)(C) defines a state audit agency to mean "any state agency, body, commission, or entity" charged with reviewing state programs. This definition apparently would include legislative oversight committees, even those with a single member. Is a vast universe of qualified recipients necessary?

4. The Provisions On Common Agencies Should Be Clarified and Narrowed.

The provisions on the use of common agencies are highly unsatisfactory. By permitting a common agency to be designated by as few as four states, it is possible that multistate taxpayers will not only have to accommodate tax auditors from each state, but from as many as 12 common agencies (assuming each state may designate only one common agency, another factor the Bill should make clear). This is particularly troublesome because it does not appear that an audit by the common agency and its constituent states will be mutually exclusive. To the contrary, it would seem reasonable to expect that after the common agency completes its examination, each of its constituent states will wish to review this examination to determine whether the common agency has applied its rules properly. Therefore, safeguards should be provided to limit both the number of designated agencies and the overlap of the examinations of the common agency and the states it represents.

D. Effective Date.

1. The Effective Date of the Bill Should Be Delayed.

The effective date of the Bill, December 31, 1986, should be set back. It likely will require more time than the proposed effective date allows before taxpayers and the federal government can be ready to implement the Bill. In particular, there will not be enough time to develop a federal administrative framework in response to the Bill if the Treasury and Internal Revenue Service resources are simultaneously burdened by the implementation of major changes to the other provisions of the Internal Revenue Code. Furthermore, corporations will have to develop compliance systems to gather the data required by the Bill. Accordingly, because of the need for regulations in several substantial areas of the Bill, the effective date of the Bill should be deferred to the later of 12 months after the date of enactment or 12 months after regulations have been promulgated thereunder. Another alternative may be for Congress to mandate the issuance of temporary regulations by a specified date so that they will be available to assist taxpayers in preparing their initial spreadsheets. However, if this course of action is followed, in no event should the effective date be before 12 months after the date of enactment.

STATEMENT OF EXXON CORPORATION
COMMITTEE ON FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HEARINGS ON S.1974 AND S.1113
SEPTEMBER 29, 1986

As a company that operates in the United States and directly or indirectly in over 80 foreign countries, Exxon is concerned with the problem of developing workable rules for attributing the income of a multijurisdictional business to operations within any particular state of the United States. While reasonable people may differ as to the most appropriate method of income attribution among the states, we believe that there is an overriding need for the states to apply a consistent framework to avoid duplicative taxation and refrain from adversely impacting international commerce.

Thus, Exxon has, for more than 20 years, actively participated in efforts by business and state representatives to develop a framework for consistently determining the amount of income reasonably assignable to each state taxing jurisdiction for companies operating in more than one state or country.

In the mid-1960's, Exxon and other members of the business community, as well as leading state tax administrators, became convinced that before following the path of federal intervention as recommended by the Special Subcommittee on State Taxation of Interstate Commerce (the Willis Subcommittee), a concerted effort should be made at the state level to develop a more orderly approach to carving up the income of multijurisdictional businesses.

Exxon, therefore, supported the efforts of a group of states to establish the Multistate Tax Compact to:

1. Facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

However, efforts by representatives of the business community and the states to develop a consensus on how to achieve these goals failed, and were marred by state charges that business was trying to avoid its fair share of taxes and business countercharges that the states were seeking maximum tax revenues without regard to "equitable apportionment". In the meantime, Exxon pursued the issue of appropriate income attribution rules through the court system, but to no avail.

In 1980, Exxon reluctantly concluded that a federally legislated solution was in order and filed a statement with this Subcommittee in connection with its hearings on the issue in which we took the following position:

> Exxon has consistently expressed its willingness to expose all of its U.S. source income to state taxation provided there are safeguards to prevent overlapping or duplicative taxation of the same income. To avoid such overlapping and duplication, Exxon supports a reasonable federal limit on the portion of a taxpayer's income that may be attributed to a particular state. To avoid distortion and to spare foreign (non-U.S.) corporations an unnecessary recalculation of income for U.S. state tax purposes, it would be appropriate to eliminate from any combination affiliates not doing business in the U.S., and to allow states to tax only U.S. source income determined under the federal income tax sourcing rules. The desire of the Internal Revenue Service to maximize U.S. source income for federal tax purposes would seem to offer adequate protection to states.

Exxon believes this position is as sound today as it was six years ago.

In 1983-1984, Exxon participated in the lengthy effort by the President's Worldwide Unitary Taxation Working Group to develop an approach which would satisfy the tax enforcement concerns of the states while avoiding the extraterritorial state taxation of income from operations outside the United States which U.S. and foreign based multinationals find so objectionable.

The Working Group agreed that the following three principles should guide state taxation of the income of multinational corporations:

Principle One:	Water's edge unitary combination for both U.S. and foreign based companies.
Principle Two:	Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
Principle Three:	Competitive balance for U.S. multinationals, foreign multinationals and purely domestic businesses.

State and business representatives, however, were unable to reach agreement on the proper state tax treatment of foreign-source dividends and of U.S. incorporated corporations operating primarily abroad (so-called "80/20 corporations").

The efforts of the Working Group did provide the impetus for another effort by the states and business community to resolve this foreign income issue at the state level.

However, in spite of a concerted effort by Exxon and other members of the business community to develop a satisfactory solution state-by-state, the problem remains unresolved as there are three states that continue to use the worldwide unitary method and twenty-seven that tax in some degree foreign source dividends.

As a result, we feel compelled to turn again to Congress and urge that you favorably consider federal legislation which permits each state to tax income reasonably attributable to operations within its borders but prohibits taxation of income generated elsewhere.

We continue to believe that the best approach is simply to exclude all income from sources outside the United States, as determined under federal income tax sourcing rules (Internal Revenue Code sections 861-864), from the calculation of income attributable to any particular state. Such an approach would balance the need for the United States to speak with "one voice" internationally while at the same time permitting states to meet revenue needs, protecting both taxpayers and the states from substantial over or under attribution of income. This approach would also be preferable to either S.1974 or S.1113 as currently written, although either bill if modified as suggested below would certainly be an acceptable solution to the worldwide unitary controversy.

S. 1974 - Unitary Tax Repealer Act

S.1974, introduced in the Senate on behalf of the Administration on December 18, 1985 by Senator Wilson (R-CA), would permit states to allow taxpayers to elect to be taxed on a worldwide unitary basis, but would generally (although not totally) prohibit states from imposing income tax on any taxpayer on a worldwide unitary basis. It also restricts the ability of states to tax foreign source dividends and imposes a number of new information reporting requirements regarding a taxpayer's aggregate state taxable income, allocation factors, tax payments, and stock investments in related companies (the so-called "domestic disclosure spreadsheet"). While superior to current law's total lack of restraint on state use of worldwide unitary taxation, we feel S.1974 should be improved in several important respects.

Absent a taxpayer election, the bill should prohibit states from using the worldwide unitary method in all cases. The definition of the water's edge group should not include (as it currently can) 80/20 companies, foreign sales and possessions corporations, or any other foreign corporations. The bill should also require states to exclude 100%, rather than 85%, of foreign source dividends from the income base.

In addition, the Secretary should not be given authority to add to the information requirements of the spreadsheet, nor should corporations have to be listed on the spreadsheet when the reporting corporation or the common owner have less than a controlling interest in such corporation. Finally, the bill should not specifically authorize the states to use the spreadsheet filings as the basis for state civil and criminal penalties for negligence, fraud, or material understatement of income or tax liability because the returns actually filed with the states should suffice for this purpose.

S.1113

S.1113, introduced in the Senate on May 9, 1985 as part of the continuing effort by Senator Mathias (R-MD) to prohibit states from including foreign corporations in a "worldwide combination" to calculate a multinational corporation's taxable income, accomplishes this result by prohibiting the states' from taxing an affiliates foreign source income until it is includable in the parent's gross income, and then only to the extent that the parent's aggregate foreign income tax rate is less than 46%.

S.1113 should be modified so that, unlike the current version, it clearly prohibits states from taxing a domestic parent corporation's foreign source operating income or the income of 80/20 companies.

The bill should also be modified to include an ownership test in its definition of "affiliated group", as well as some indication of how brother-sister controlled groups and combined groups should be treated.

Conclusion

In summary, Exxon believes the time has come for federal legislation which will write a definitive end to the long-running worldwide unitary taxation controversy. The method has become a constant irritant in our international trade relations and frequently leads to international double taxation. Further, even though the recent trend has been for the individual states to more or less abandon the method, it could reemerge as a major controversy at any time so long as states are unrestrained by federal legislation.

We would be pleased to work with the Congress, the states, and other interested parties in reaching a reasonable federal legislative solution as soon as possible.

October 1, 1986

Statement

of

HOUSEHOLD INTERNATIONAL, INC.

on

Pending Federal Legislation Prohibiting State Taxation on the Worldwide Unitary Basis, Restricting the State Taxation of Foreign-Source Dividends, and Imposing New Information Reporting Requirements on Multistate and Multinational Corporations

September 29, 1986

Household International, Inc. is a diversified Fortune 100 corporation with business operations located in all fifty states and major foreign countries. The President's Working Group on unitary taxation called for the prohibition of the worldwide unitary method of taxation as well as, the equitable taxation of foreign-source dividends, as a means to achieve a competitive balance between U.S. and foreign based multinational businesses. As a corporation deeply concerned with the achievement of these objectives, we appreciate the opportunity to state our position on S. 1974 and H.R. 3980 which address the worldwide unitary tax problem and related issues.

Household International, Inc. supports the enactment of federal legislation to resolve the worldwide unitary tax conflict and, consequently, supports the goals of S. 1974 and H.R. 3980. However, we have strong reservations with the proposed legislation as it currently stands and suggest certain modifications which we feel are absolutely necessary in achieving a fair and equitable federal solution to the problems associated with worldwide unitary taxation.

Our comments and suggested modifications are set forth below and are organized under two general headings both relating to specific sections contained in the proposed federal legislation: (1) Section 7518(b). State Taxation of Foreign-Source Dividends; and (2) Section 6139(A). Information With Respect to Certain Multistate and Multinational Corporations.

HOUSEHOLD INTERNATIONAL, INC.'S POSITION ON PENDING FEDERAL LEGISLATION (S. 1974 AND H.R. 3980)

I. Proposed Section 7518(b). State Taxation of Foreign-Source Dividends

Proposed Section 7518(b) prohibits states from taxing more than an "equitable portion" of foreign-source dividends. This restriction may be met if the state:

a) excludes at least eighty-five percent (85%) of such dividends from the taxable base,

b) excludes the portion of the dividends from the taxable base that effectively bears no income tax after application of the foreign tax credit; or

c) adopts a method of taxation that results in equitable taxation of the dividend pursuant to regulations to be issued by the Treasury Secretary.

Household International, Inc. believes that proposed Section 7518(b) is inadequate for the following reasons:

a) Although standards or guidelines are established for determining what constitutes an "equitable portion" of foreign source dividends, these guidelines are are only that - guidelines - and are not mandatory on the respective states. Consequently, what constitutes an "equitable portion" remains a matter of state interpretation.

b) Foreign-source dividends are not specifically defined. It is uncertain whether the limitations imposed under Section 7518(b) are also applicable to foreign dividend gross-up defined under I.R.C. Section 78 and subpart F income under I.R.C. Sections 951-964.

c) There is no restriction on the taxpayer's state of legal or commercial domicile regarding the taxation of foreign-source dividends. Therefore, the taxpayer's state of legal or commercial domicile could impose a water's-edge method of taxation and still fully tax the foreign-source dividends of the recipient. This is precisely the inequity addressed by the President's Working Group and agreed to be corrected in all proposed water's-edge legislation.

In order to correct the vagueness currently existing in Section 7518(b), Household International, Inc. proposes the following modifications:

a) Section 7518(b) should specifically provide for the elimination from taxation of at least eighty-five percent (85%) of foreign-source dividends actually received or deemed received by the taxpayer. All alternatives in determining what constitutes an "equitable portion" of a taxpayer's foreign-source dividends should be deleted. (Page 3, Lines 7-14)

b) Since the taxation of foreign-source dividends at eighty-five percent (85%) acknowledges the nondeductibility of appropriate related expenses, Section 7518(b) should specifically provide that no state shall disallow a taxpayer's deductions or credits as an offset against such dividends if such disallowance would have the effect of including in the state's income base more than fifteen percent (15%) of such dividends.

c) Section 7518(b) should specifically provide for the elimination from taxation of foreign dividend gross-up defined under I.R.C. Section 78 at one-hundred percent (100%).

d) The limitations imposed under Section 7518(b) should apply to all states, regardless of whether a particular state is the commercial or legal domicile of the taxpayer/recipient. As a result, the exception to Section 7518(b) for a state of commercial or legal domicile should be deleted. (Page 3, Lines 15-17).

e) Section 7518(c) should define foreign-source dividends to include subpart F income under I.R.C. Sections 951-964 and other foreign-source dividends received or deemed received by the taxpayer (including I.R.C. Section 1248 gain and consent and deemed dividends).

II. Proposed Section 6039A. Information With Respect to Certain Multistate and Multinational Corporations

Household International, Inc. questions whether the significant reporting requirements contained in proposed Section 6039A and their attendant administrative cost to taxpayers, have been adequately justified. The compliance requirements for corporations subject to proposed Section 6039A are at least as burdensome as those currently associated with the worldwide combined report method, even though the amount of useful information presented to the states is minimal and already available to the states without federal intervention. Unless proponents of the federal disclosure spreadsheet can better articulate their need for such information, we believe the burdens to taxpayers are unwarranted and that proposed Section 6039A should be deleted in its entirety.

Notwithstanding the foregoing comments, should Congress still feel compelled to include the disclosure requirements in the proposed legislation, the following suggests certain modifications which we feel are necessary to ensure that the legislation is equitable and capable of consistent administration.

1. PRESUMPTION OF CONSISTENCY IN STATE LAWS

The basic problem with the domestic disclosure spreadsheet is that it presumes state tax law and its interpretation are the same in each state. This is not the case. Each state has its own set of laws, the interpretation of which is made by each state's own tax administration and judicial system. What has consequently developed is a system of taxation unique on a state-by-state basis. As such, the spreadsheet will inevitably result in the disclosure of filing positions which are inconsistent on a state-by-state basis. The fear is that these inconsistencies will be assumed to evidence taxpayer error and cause each taxing state to ignore its established guidelines and to adjust the returns in accordance with the position most favorable to the state.

In order to alleviate this fear, it is suggested that Section 6039A also subject states to certain disclosure requirements. For example, a requirement that all states file the results of each completed audit with the I.R.S. would allow taxpayers to monitor state tax administration and to determine whether the respective tax laws are being properly and consistently applied.

2. ADMINISTRATIVE BURDEN AND COST

Because states have a right to most, if not all, information required by Section 6039A, one major effect of the spreadsheet is that the compilation and analysis will now become the responsibility of the taxpayer rather than the state auditor. This is a significant shift of the audit burden to taxpayers which adds another layer of administrative effort and cost. The information and disclosure spreadsheet requirements are far removed from the objective of simplification. Based on 1985, Household International, Inc. would have had to submit information and disclosure spreadsheets for 137 separate, affiliated multistate corporations. It will take substantial effort to accumulate the required data and arrange it on the disclosure spreadsheet to each state's satisfaction, given the different laws in the respective states.

3. USE OF ONE COMMON AGENCY

Under the proposed legislation, any information with respect to a Section 6039A reporting corporation could be disclosed to a "common agency". Common agency is defined in Section 6039A(d)(4)(A) as any agency designated by "four or more States" to assist in the administration of the income tax laws of such States. Consequently, more than one common agency could be authorized to receive disclosure information. This situation would compound the administrative burdens noted in section two above. Section 6039(d)(4)(A) should be amended to limit information disclosure to a single common agency designated by all states collectively in administering the disclosure spreadsheet. (Page 19, Lines 2-10)

4. FEDERAL FILING SHOULD NOT CONSTITUTE AN ORIGINAL STATE FILING

The filing of the information return required by proposed Section 6039A should not be considered an original state return filing. Due to the extent of information requested, it is conceivable that the federal disclosure return could be filed after the designated due date. As proposed, the taxpayer could be subject not only to the federal penalty, but to civil and cirminal penalties from each participating state as well. The imposition of additional state penalties is in our opinion, duplicative, harsh and improper and recommend that proposed Sections 6039A(d) and 6039A(e)(3) be deleted in their entirety. (Page 13, Lines 13-24; Page 14, Lines 1-2, Lines 20-24).

5. NEED FOR REASONABLE CAUSE EXCEPTION

As noted in the preceding section, taxpayers are subject to federal as well as state penalties, notwithstanding a good faith effort at compliance. Although we first believe that there should be a prohibition against multiple federal-state penalties, the subjective nature of the requested information requires, at the least, a reasonable cause exception to the penalty imposed under Section 6039A(e).

6. INFORMATION REQUESTED SHOULD BE DEFINITIVE

Section 6039A(a) language which provides for the reporting of "such other information required as the Secretary may by regulation prescribe" should be deleted. The burdens known to exist with respect to this legislation are already substantial and should not be allowed to be expanded to include additional unknown burdens. (Page 9, Lines 3-5)

7. DISCLOSURE REQUIREMENTS SHOULD BE RESTRICTED

Only information relevant to the conduct of a state income tax audit should be required. The disclosure requirements relating to the reporting corporation's income tax liability in each state, its income subject to tax in each state, and the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each state, should be deleted. As noted earlier, the income tax statutes vary from state to state. Even when the provisions are identical, their interpretation and application remains varied. As a result, the method of determining a corporation's income tax liability in other states under dissimilar taxing provisions is irrelevant and meaningless when determining whether the proper income tax liability has been reported in a specific state. (Page 8, Lines 15-20)

8. EXEMPTION FROM DISCLOSURE REQUIREMENTS

The establishment of the domestic disclosure spreadsheet was meant to offset the perceived revenue loss to states caused by the repeal of worldwide unitary taxation. For many taxpayers, however, there is no benefit realized from filing a unitary return on a water's-edge basis. For these taxpayers, the disclosure requirements of Section 6039A are particularly onerous. We recommend that Section 6039A provide an exemption from the disclosure requirements for those corporations that elect to remain subject to worldwide unitary taxation in those states that currently impose such method.

9. CONFIDENTIALITY OF DISCLOSURE SPREADSHEET

Section 4 of S. 1974 amends I.R.C. Section 6103, relating to confidentiality and disclosure of returns and return information. Subsection (d) effectively permits disclosure of tax reurn information to any State tax agency to the extent necessary in the administration of the tax laws of a state. We feel the broad access of this information goes well beyond the intent of the President's Working Group. Section 6103 should be amended to provide that only states that unequivably prohibit both worldwide taxation and the taxation of foreign-source dividends should be permitted access to the domestic disclosure spreadsheet.

CONCLUSION

Household International, Inc. commends Congress's and the Administration's efforts to seek a federal solution to the worldwide unitary problem. S. 1974 and H.R. 3980, although requiring significant amendments, provide a sound foundation for achieving this objective. Consequently, we urge Congress to take immediate action on this legislation. We request that the specific recommendations discussed above be taken into consideration since they are believed necessary in order to ensure that the federal solution, once realized, is both fair and equitable to both U.S. and foreign-based multinationals.

Household International, Inc. appreciates this opportunity to present our views on the pending federal legislation relating to the worldwide unitary tax problem and related issues. Should you require additional information or wish to discuss our comments further, please do not hesitate to contact the undersigned at (312) 564-6105.

Respectfully submitted,
Household International, Inc.

By: ______________________
Thomas P. Maletta
Vice President - Taxes

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Date
Your reference
Our reference
Enclosures

PROPOSED UNITARY LEGISLATION-S. 1974 & H.R. 3980

U.S. Senate Finance Committee, Hearing Before Subcommittee on Taxation and Debt Management (29 September 1986)

STATEMENT OF THE INTERNATIONAL CHMABER OF COMMERCE

1. The International Chamber of Commerce (ICC) is an international organisation representing the business community worldwide. With 7,000 members comprised of companies and business associations in more than 100 countries, the ICC works to promote the principles of a free market economy, and a fair and open system of international trade and investment.

2. The ICC has over many years consistently opposed the use of the worldwide unitary method of taxation ("worldwide unitary"). Worldwide unitary conflicts with the established principles of taxation as practised federally and internationally and acts as an impediment to the free flow of international trade and investment. The ICC has long advocated its removal and, in its place, the secure provision for international business of the unconditional right to be taxed by the States in accordance with internationally accepted principles, as is the case for federal purposes. The more specific objections to worldwide unitary have been set out on many occasions and ICC takes this opportunity to endorse the strong condemnation of the use of this method contained in Part II of Treasury Baker's letter of March 5 1986 to the Chairman of the Senate Finance Committee (copy attached for reference).

3. The ICC accordingly warmly welcomed the introduction in December 1985 of S.1974 and H.R.3980, following the President's statement of November 8 1985 announcing his support for the enactment of legislation which would require States to tax multinationals only on income derived from the territory of the United States ("the water's edge requirement"). Such legislation would thus prohibit States from reaching out beyond the United States to tax companies, by the use of worldwide unitary, on income earned outside the United States by them or by non-US companies in the same affiliated group.

4. In the view of the ICC, it is only through federal legislation that a satisfactory, universal and lasting solution will be found. That conviction is reinforced rather than diminished by the recent passage of "water's edge" legislation (S.B.85) in California. As a clear recognition of the strength of the case against worldwide unitary the California legislation is indeed to be welcomed. But as a solution to the problem of worldwide unitary it is very seriously flawed.

In particular:

(1) It does not grant an unconditional right to be taxed on the water's edge basis. Instead it makes the right to elect water's edge subject to a number of undertakings and conditions.

Most seriously, the water's edge basis is only available to a company which contracts with the State for a ten year period, on an evergreen basis, to pay an annual fee calculated as a percentage of its California payroll, property and sales.

(2) The State retains the power, in a range of circumstances in which normally a financial penalty would be the appropriate sanction (and in which indeed the State does in addition impose the customary financial penalties), to disregard a company's water's edge election with retroactive effect and to subject it mandatorily to worldwide unitary.

The protection afforded by the California legislation is thus hedged about with conditions and uncertainty. The door is left open to the mandatory reimposition of worldwide unitary. Further, payment (the annual fee) is demanded as the price for being taxed on a basis consistent with that practised federally and internationally, rather than on a basis (worldwide unitary) which has been so widely and powerfully condemned by the federal government, by the major trading partners of the US and by international business, both US and foreign, for the reasons already mentioned.

5. The ICC therefore urges the Committee to give urgent and favourable consideration to S.1974.

6. We leave detailed comment on S.1974 to others but would draw the Committee's attention to two features we regard as unsatisfactory.

First, contrary to the President's announcement and to the statement in the transmittal letters to Congress that the legislation would "prohibit states from imposing corporate income tax on a worldwide unitary basis", S.1974 as drafted would still permit States to apply worldwide unitary mandatorily in certain circumstances. It would not, for example, prevent the introduction of onerous requirements of the sort which have appeared in certain state bills (such as payment of fees, undertakings as regards the location of investment) into their tax laws, the taxpayer's failure to comply with which would entitle a State to resort to worldwide unitary.

The ICC urges that S.1974 be amended so as to provide clear and guaranteed protection, thus removing all uncertainty.

Second, the ICC notes that the bill proposes to include within the water's edge certain foreign corporations whose nexus with the United States is slender or even, in some cases, non-existent. The ICC urges therefore that the water's edge boundary be drawn on a basis compatible with the permanent establishment approach, thus clearly confining the States' taxing powers to income derived from the territory of the United States.

7. In concluding, the ICC again warmly welcomes the positive initiative which has been taken and looks forward to a satisfactory resolution of this long-standing problem by the early passage of the bill, suitably amended.

ANNEX TO DOCUMENT NO 100/278 OF

THE SECRETARY OF THE TREASURY
WASHINGTON

March 5, 1986

Bob

Dear ~~Mr. Chairman~~:

S. 1974, introduced by Senator Wilson, as well as Senators Mathias and Hawkins, in the Senate on December 18, 1985, would generally prohibit states from levying corporate income taxes on a worldwide unitary basis. This legislation falls within the jurisdiction of the Senate Finance Committee. The bill was drafted by the Treasury Department at the express direction of the President and has the full support of the Administration. I have attached for your consideration a copy of the President's statement of November 8, 1985 on the worldwide unitary tax issue, directing me to prepare and submit this legislation to Congress. A technical explanation of the bill, providing a complete description of its provisions, is also enclosed. This letter is intended to provide you with background on the worldwide unitary tax issue and to describe the serious concerns that have led the Administration to propose and support this legislation.

I. Description of Current State Corporate Income Tax Practice

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are in use for making this determination: separate accounting and worldwide unitary combination.

Separate accounting is the method of taxation in use generally throughout the world and is employed by the federal government. Under separate accounting, taxable income is determined separately for each individual corporation. Any improper income or profit shifting between related corporations for tax avoidance purposes is corrected by requiring "arm's length" pricing in related party transactions. That is, flows of goods and services between related or commonly-owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length. Under the separate accounting method, double taxation between jurisdictions is relieved either through exemption from tax by the residence jurisdiction (usually the place of incorporation or management control) of income derived in the source jurisdiction (the place the income is earned), or by the residence jurisdiction granting a credit for taxes paid to the source jurisdiction. The United States federal tax law uses the latter approach.

The alternative method, worldwide unitary combination, is currently used by seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah*) to determine a multinational enterprise's state corporate tax liability. Under this approach, the business income of all individual companies in the commonly controlled enterprise which operate in the same general line of business (the "unitary business") as the corporation or corporations subject to the state's taxing jurisdiction is aggregated, regardless of (i) whether the other individual companies are foreign or domestic; (ii) whether the other individual companies have a tax nexus with or presence in the state in question; and (iii) whether the income of the other individual companies would be treated as derived from foreign or domestic sources under federal tax rules or generally accepted international taxation principles. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of a formula which is intended to measure how much of the activity of the unitary business (and hence its income) is attributable to the taxing jurisdiction.

The apportionment formula generally used is based on relative amounts of payroll, property, and sales. If, for example, 25 percent of the payroll, property, and sales of the unitary group is located in the taxing jurisdiction, then 25 percent of the group's aggregate income from the unitary business would be apportioned to that state. Because the apportionment formula is considered to assign the appropriate amount of income to a particular state, no further measures are taken to relieve any multiple taxation of the same income which may arise from the use of different income sourcing rules by other taxing jurisdictions.

Under the worldwide unitary method, dividends paid by one corporation to others within the unitary business group are eliminated as intercorporate transfers. Under separate accounting, in contrast, intercorporate dividends are recognized explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A "water's edge" limitation on the unitary method, i.e., excluding foreign corporations, would respect the separate entity status of related domestic and foreign corporations. It therefore gives rise to the question of how dividends received by a U.S. corporation that is a member of a "water's edge" unitary group from a foreign corporation that is not a member of the "water's edge" group should be treated for state tax purposes. The question of state taxation of foreign-source dividends is thus inextricably linked to the issue of worldwide unitary taxation and, as described below, is therefore addressed in the proposed legislation.

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* Utah has adopted administrative rules that would abandon worldwide unitary taxation upon implementation of certain federal assistance measures, including the enactment of the federal assistance legislation contained in the proposed bill and described in section IV, below.

Under present law, state taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. Though dividends from a domestic corporation are subject to tax in nearly all states with a corporate income tax, most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is largely to exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation (and thus taxation) to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

II. Reasons for Administration Opposition to Worldwide Unitary Taxation

It has been the longstanding policy of the United States to favor the separate accounting method for allocating income among nations for purposes of taxation. This policy is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. The model tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") specify that transnational income is to be taxed on a separate accounting basis. Thus, continued state worldwide unitary taxation is directly in conflict with federal and internationally accepted practice and impedes the ability of the federal government to pursue this policy in its international dealings.

During the debate over worldwide unitary taxation, foreign governments have repeatedly petitioned the federal government to act to curb state use of the worldwide unitary method. Diplomatic notes articulating the problems caused by state worldwide unitary taxation have been received from virtually every developed country in the world, including Canada, the United Kingdom, Germany, France, Belgium, the Netherlands, Italy, Switzerland, Japan, and Australia. The United Kingdom, in July, 1985, adopted anti-unitary retaliatory legislation that would permit the U.K. government to effectively increase the U.K. tax on dividend distributions from U.K. subsidiaries to their U.S. parent corporations operating in worldwide unitary states. If implemented, this legislation would clearly violate the U.S.-U.K. bilateral income tax treaty. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having an adverse effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States. (The U.K. has now agreed to defer implementation of this legislation for the time being.) The adoption of this legislation by the U.K. illustrates that state worldwide unitary taxation is clearly adversely affecting the United States' foreign economic relations.

Foreign governments and businesses that are subject to worldwide unitary taxation argue that this method of computing state tax gives rise to double taxation of foreign income. They also contend that worldwide unitary taxation is administratively burdensome, particularly for foreign owned companies. These results are inevitable as long as a few states rely on a method of measuring income that is different from the approach used by the rest of the world.

Theoretically, if all jurisdictions, domestic and foreign, were to adopt a uniform unitary method of taxation, and apply it consistently, there would be no double taxation as the formula would not apportion the same income to more than one jurisdiction. The problem, however, arises from the fact that combined reporting on a worldwide unitary basis is a distinctly minority practice. In an environment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs, property values, and profitability can vary greatly among countries, an income measurement system based on formula apportionment is in open conflict with the international standard of separate accounting. This is because formula apportionment assumes all parts of a unitary business are equally profitable whereas separate accounting acknowledges that individual corporations can earn different rates of return. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis.

State use of the worldwide unitary method also creates administrative burdens for taxpayers. There are substantial costs associated with collecting and converting accounting data generated by the various foreign affiliates of the unitary group to a form consistent with U.S. standards. These burdens can be particularly acute for foreign-owned companies which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other purpose.

The use of the worldwide unitary method by some states may also inhibit and distort the international flow of investment capital. In the words of one foreign government, "[t]he [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." Consequently, according to a group of foreign governments, worldwide unitary tax constitutes "...a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). The United States is strongly committed to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer. Some states may be in a position in which their use of the unitary method causes foreign investors to turn away from the United States altogether (rather than shift investments to other U.S. states).

In September 1983, in response to complaints raised by both the U.S. and foreign business community and foreign governments over the Supreme Court decision in Container Corp. v. Franchise Tax Board, President Reagan asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group. This group was composed of representatives of the federal government, state governments, and the business community and was asked to provide recommendations suitable for resolving the issues raised by worldwide unitary taxation.

At its final meeting on May 1, 1984, the Worldwide Unitary Taxation Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

Principle 1: "Water's edge" unitary combination for both U.S.- and foreign-based companies.

Principle 2: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle 3: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

While the first and third principles were to be adopted voluntarily on a state-by-state basis, Principle 1, in particular, represented a clear recognition by the Working Group that the separate accounting method was superior to the worldwide unitary method in the international context. The Administration was very hopeful that the states would be able to resolve the worldwide unitary problem along the lines advocated by the Working Group on a voluntary basis without resort to federal legislative intervention.

Since the adoption of the Working Group Report some states have changed their laws to conform to the Working Group principles. Florida, Colorado, Indiana and Oregon have ceased taxing on a worldwide unitary basis. A Massachusetts court decision imposed limitations on that state's use of the worldwide unitary method and the state legislature has to date refrained from taking any action that would permit application of that method in the face of the judicial decision. However, seven other states continue to use the worldwide unitary method. In particular, efforts in California to enact legislation limiting worldwide unitary taxation have foundered in the past two legislative sessions, most recently when the California legislature adjourned for the year in September, 1985 without taking action on the issue.

In transmitting the report of the Working Group to the President, Secretary Regan indicated that he would recommend restrictive federal legislation if substantial voluntary progress had not been made on the worldwide unitary issue at the state level by July 31, 1985. That date has long since passed. We now believe that the time has come for Congress to act to finally resolve this serious international economic problem.

III. State Taxation of Foreign-Source Dividends

The taxation of foreign-source dividends is directly related to the issue of worldwide unitary taxation. A limited resolution of the worldwide unitary issue -- such as an agreement by states not to impose worldwide unitary tax but with no restriction on the taxation of foreign-source intercorporate dividends -- would cause other serious problems. In effect, this would be a "foreign only" situation, freeing foreign-owned multinationals from the yoke of worldwide unitary taxation while subjecting U.S. based multinationals to full taxation on their foreign dividend income. Such a "foreign only" solution, if adopted, would disadvantage domestically controlled businesses. The Working Group's third principle recognizes the need for competitive balance for domestic multinationals, foreign multinationals, and purely domestic businesses. That principle requires that legislation restricting state unitary taxation also address the question of equitable state taxation of foreign-source dividends. Unrelieved state taxation of foreign dividends is not consistent with Principle 3.

Unrestricted state taxation of foreign dividends would subject domestic businesses to serious double taxation of foreign income. Federal tax policy has long been characterized by its commitment to avoid international double taxation. Indeed, the United States has been a leader in a worldwide effort to establish taxing rules under treaties and commonly accepted principles that minimize international double taxation. If a clear federal policy is not to be undercut by state action, states must comply with this policy of eliminating double taxation and therefore be limited to taxing some equitable portion of foreign source dividends.

The legislation does not mandate that any specific method of dividend taxation be imposed on the states. In our view, arguments of state fiscal sovereignty strongly indicate that states should have leeway to tailor their own systems of taxation to the extent that they do not cause serious foreign commerce difficulties by resulting in systematic overtaxation and double taxation of U.S. business in contravention of established federal and international policy. The legislation therefore provides in broad terms for the equitable taxation of dividends and suggests certain guidelines that states could follow in satisfying that standard. As an illustration of the flexibility of the approach, the legislation would accept as appropriate the treatment of dividends in such states as Colorado, Oregon, Florida and Illinois, states which have been intimately involved in the worldwide unitary tax controversy.

IV. Information Reporting and Other Federal Assistance

States have legitimately contended in the Working Group and elsewhere that they lack the resources and ability to monitor adequately transactions between members of a water's edge unitary group and related foreign companies outside that group. The Treasury Department agreed with recommendations of the Working Group to provide appropriate federal assistance to the states in order to assure proper working of the separate accounting method. The Working Group suggested that an annual information return be filed with the Internal Revenue Service by multinational companies. This return would in turn be shared with the states and with multistate audit agencies and would provide states with some assurance that corporations had allocated and apportioned the appropriate share of the corporation's income to each state. The report would also identify those related companies with which serious income shifting would be most likely to arise. In the summer of 1985, the Treasury Department published for comment a draft of legislation implementing this reporting system. Section 3 of the bill is based upon that draft after taking into account the many comments received from affected businesses and the various states. We believe that the information reporting system provided for in the bill is an integral part of the solution to the worldwide unitary problem.

In order to provide states with greater assistance the Treasury Department also indicated in the Working Group an intention to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. I urge your assistance in approving the increased budget appropriations that are being requested for this purpose.

Conclusion

I strongly urge the prompt and favorable consideration of this legislation by the Finance Committee. The serious foreign commerce difficulties caused by the use of the worldwide unitary tax method by a few states must now be resolved.

OMB has advised that there is no objection from the standpoint of the Administration's program to the presentation of this legislation to the Congress and that its enactment would be in accord with the program of the President.

Sincerely,

Jim

James A. Baker, III

The Honorable Bob Packwood
Chairman, Finance Committee
United States Senate
Washington, D.C. 20510

Mobil Corporation

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OFFICE OF TAX COUNSEL

THOMAS J. DU BOS
TAX LEGISLATIVE COUNSEL

October 1, 1986

The Honorable John H. Chafee
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567 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Chafee:

I appreciated the appointment to appear before your subcommittee on September 29 on behalf of the National Association of Manufacturers to testify in favor of S.1974. I would like to offer some additional comments on behalf of Mobil Corporation.

Perhaps the single most important aspect of S.1974 is that it provides a uniform method by which both U.S. and foreign multinational companies may be taxed by the various states on a fair basis irrespective of the companies' country of incorporation. This "level playing field," so long sought by U.S. multinationals, will remove the competitive disadvantages that are present in a number of States including California which have purportedly repealed worldwide combination in favor of a water's edge method of taxation. In fact, worldwide reporting continues to be the norm in California while the option to elect water's edge requires a substantial annual fee and a ten-year commitment to remain on water's edge. Indeed, California's elective water's edge method does not even take effect until 1988.

At the hearing you expressed an acute concern about situations in which U.S. companies are placed at a disadvantage with respect to their foreign competitors as a result of state taxation. You requested a submission of information detailing instances of such discrimination.

I believe that we need look no further than to examine state taxation under the worldwide unitary concept or the water's edge combination as practiced by California and a number of other states, such as Indiana, Minnesota, Maine, Nebraska, New Hampshire, Oregon and Kansas for an illustration of how U.S. states generate an uncompetitive economic climate for U.S. multinationals.

The most prominent specific abuse is to exclude from state taxation the income earned by a foreign multinational from its business operations abroad while subjecting to state tax the same type of income earned abroad by a U.S. multinational. Montana was cited at the hearing as a classic example of this type of discrimination by a state using the worldwide method of taxation.

In general, there are two major areas in which states (including California beginning in 1988) that are not using the worldwide method are taxing U.S. and foreign multinationals differently. These areas involve the taxation of 80/20 companies and foreign dividends. These two areas, which are described below, are largely responsible for creating the uncompetitive business climate experienced by the U.S. multinational in connection with state income taxes.

The lack of a level playing field is illustrated in the case of 80/20 companies. As you know, 80/20 companies are U.S.-incorporated companies which perform substantially all (80% or more) of their business activities outside the U.S. These companies are subject to foreign taxation in jurisdictions in which they conduct business. Under the recently-enacted California water's edge method of taxation, the foreign source before-tax income of 80/20's is included in the California tax base without deduction or credit for the income taxes paid to foreign governments. This not only results in double taxation but creates the absurd situation of a tax on a tax, e.g. amounts which have been paid to foreign governments as income taxes are included in the water's edge income base and subjected to additional tax in California. The same situation prevails in Minnesota, Maine, Nebraska, Oregon and Kansas. In many cases, particularly in the oil industry, the rate of foreign income tax is far in excess of the rate of U.S. corporate income tax.

Because foreign multinationals usually conduct business outside the U.S. through foreign-incorporated companies, the foreign multinationals' before-tax income from foreign sources is completely excluded from taxation in California and other states under the water's edge method. By itself this is a major state tax burden which must be overcome by U.S. multinationals if they hope to compete successfully with foreign companies.

A second significant area of taxation by states which results in discrimination and lessened competition is in the taxation of dividends received from foreign operating subsidiaries of U.S. multinationals. The methods of taxation differ widely among the States, e.g. both Indiana and New Hampshire use the water's edge method and exclude both 80/20 companies and foreign incorporated subsidiaries from the tax base but include all foreign source dividends. A serious competitive problem is created to the extent that foreign source dividend income is subject to state taxation. This is particularly true since the states do not include in the taxpayer's apportionment factors the foreign property, payroll and receipts that generated the foreign dividend income.

Foreign multinationals with parents headquartered outside the U.S. are clearly not subject to state taxation on dividends from foreign operations. Some would argue that the foreign countries tax the foreign multinational's dividend and therefore a balance is created between the U.S. and foreign multinational company. In most cases this argument is wrong. Foreign countries generally tax on a territorial basis. Under this method dividend income earned outside the taxing country which is received by a resident of the country is exempt from local taxation. The net result is that a portion of the dividend received by a U.S. multinational is taxed by various states while similar dividends received by foreign multinationals escape tax.

While it may be true that in a perfect world, "all things being equal," foreign and U.S. multinationals, as well as purely domestic business, will pay the same income tax on their business in Montana, to use the example referenced in the subcommittee hearing, the fact is that all things are not equal. Far from it.

Multinational business must contend with fluctuating exchange rate conversions in determining apportioned foreign source income for state income tax purposes, while this is not a problem for purely domestic business .

Furthermore, for an apportionment formula to work fairly, the factors (receipts, property and payroll) which form the numerator and denominator of the apportionment fraction and which therefore decide the amount of income to be allocated to a specific state, must have a degree of uniformity in labor and property costs in both the numerator and denominator. This does not exist in the real world in international operations where foreign labor and property costs are often much lower than in the U.S. For example, in order for the apportionment of income formula to work properly, it is necessary that each dollar of property and payroll expended generate a relatively uniform level of profit wherever employed. In realty this assumption is seriously flawed and generally works to the detriment of multinational business in connection with U.S. state taxation of worldwide income. To illustrate, the generally higher labor and property costs incurred in the U.S. to produce income versus the Middle East, Asia, Africa, South America and even Europe draws a disproportionately higher amount of total worldwide income to the U.S. states. This occurs because the higher U.S. costs go into the numerator of the apportionment fraction while at the same time the generally lower level of foreign labor and property costs go into the denominator of the apportionment fraction. The lower foreign costs combined with often higher productivity in foreign areas result in higher foreign profits being taxed by the U.S. states. This perverse result is found when we examine oil producing costs and productivity in the U.S. versus foreign areas, particularly in third world areas, where large amounts of Mobil's income is generated.

Indeed, in Mobil's case, the state tax on foreign tax and the extreme differences in oil well productivity and costs of operation (property and payroll) between U.S. and foreign areas results is a large misattribution of 80/20 company income to the U.S. states. This income is being taxed in U.S. states such as California, Maine, Minnesota, Nebraska, Oregon and Kansas which include 80/20 companies in their water's edge tax base.

The U.S. Supreme Court has invited the U.S. Congress to resolve the disparities existing in state taxation. Mobil believes that only federal legislation will provide permanent, uniform and fair rules among the states in the taxation of U.S. and foreign multinationals. S.1974 would achieve this desired result and end the competitive disadvantages experienced by U.S. multinationals.

The President's Working Group set out the following three principles which are embodied in S.1974:

a) States repeal worldwide unitary combination and adopt a water's edge combination

b) equitable taxation of dividends on a uniform basis by states

c) competitive balance among foreign multinationals, U.S. multinationals and domestic companies.

It was the intent of the Working Group that multinational taxpayers receive the protection which is granted by S.1974 and in return those taxpayers would make available information required by the states to assure that income was correctly reported. This concept was embodied in the proposed "spreadsheet" portion of the legislation. Clearly, however, the benefit of the spreadsheet information must be contingent on passage of S.1974 or similar legislation. Any other result would further burden multinational taxpayers with an extraordinary administrative cost and workload without receiving the protection afforded by the principles of the Working Group.

We are grateful to you and the members of the subcommittee for having held the hearings on September 29 and we hope the testimony presented there will aid in the passage of legislation such as S.1974 during the early stages of the 100th Congress.

Thank you for the opportunity to present these views on behalf of Mobil Corporation.

Yours very truly,

Thomas J. DuBos
Tax Legislative Counsel

TJD:iq
1140Q

National Governors' Association

Bill Clinton
Governor of Arkansas
Chairman

Raymond C. Scheppach
Executive Director

TESTIMONY OF

RAYMOND C. SCHEPPACH
EXECUTIVE DIRECTOR

NATIONAL GOVERNORS' ASSOCIATION

on behalf of

THE NATIONAL GOVERNORS' ASSOCIATION

before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

regarding

WORLD-WIDE UNITARY TAXATION
and
STATE TAXATION OF FOREIGN SOURCE DIVIDENDS

OCTOBER, 16, 1986

HALL OF THE STATES · 444 North Capitol Street · Washington, D.C. 20001-1572 · (202) 624-5300

Mr. Chairman:

The National Governors' Association appreciates the opportunity to provide you with written testimony concerning proposed federal legislation, S. 1974 and S. 1113, intended to preempt the authority of states to utilize the world-wide unitary method of taxation and tax foreign source dividends. In my statement I will address three issue areas that I believe you should examine:

1. the present use by states of the world-wide unitary method of taxation and the taxation of foreign source dividends;
2. reasons why no federal preemption of state authority is appropriate; and
3. reasons why federal assistance to states in their taxation of multi-national corporations is appropriate.

Present Use

In 1982, there were thirteen states - Alaska, California, Colorado, Idaho, Illinois, Indiana, Massachusetts, Montana, New Hampshire, New York, North Dakota, Oregon, and Utah - that utilized the world-wide unitary method of taxation. These states were later joined by Florida. California collected approximately $500 million of the $700 million attributed to the use of that method. At present there are only three states still utilizing world-wide unitary taxation. They are Alaska, Montana and North Dakota; and it is anticipated that Montana and North Dakota will amend their legislation next year by adopting a water's edge concept of unitary taxation. By the end of 1987, only Alaska is expected to be utilizing comprehensively the world-wide unitary method, and the corporations most greatly affected there, the petroleum companies, want its use continued because it reduces their state income tax liability.

Twenty-seven states presently tax foreign source dividends, collecting between $445 million to $550 million in the process.

States which have used the world-wide unitary method of taxation contended that this method of taxing multi-national corporations is fair, efficient and produced significant income. Corporations challenging the use of unitary apportionment either on a world-wide or domestic basis have lost every challenge in the Supreme Court. Most recently in Container Corporation of America v. The Franchise Tax Board, 463 U.S. 159 (1983), in which NGA filed an amicus curiae brief on behalf of the State of California, the Supreme Court found that the use of the world-wide unitary method met due process, equal protection and foreign commerce clause constitutional standards. The Supreme Court has concluded that the use of the unitary method is as fair as the separate accounting method, a method which the Treasury Department would impose on the states and which is not always as effective in requiring multi-national corporations with numerous subsidiaries to pay their fair share of state taxes. The Supreme Court concluded that the separate accounting method had as much potential for creating the risk of double taxation with foreign governments as the unitary method.

Present state use of the unitary tax method has aroused vigorous opposition by multi-national corporations seeking to reduce their state tax liability. Foreign governments have provided verbal support for their large corporate constituents. However, the Senate has never ratified a U.S. tax treaty with a foreign government to preempt state authority to utilize the method nor has a foreign government ever taken any action against the United States for permitting state use of the method.

Rationale for No Federal Preemption

As a matter of federalism states should be able to choose their own tax system and taxing methods. NGA's adopted policy position A.-4 entitled "Avoiding Federal Preemption of State Laws and Policies" speaks to the issue. It reads in part:

> The Constitution assigns certain responsibilities to the federal government and reserves the balance for the states. Accordingly, the role of the federal government in areas reserved for states and local government should be strictly limited ....
>
> Integral to the operation of state government is the freedom to structure state revenue systems. It is essential that the federal government not preempt, either directly or indirectly, sources of state revenues, state tax bases or state taxation methods.

Nothing is more important to the states than their ability to collect revenue to finance the provision of services to their individual and corporate citizens. The unitary method is merely a technique which some states have chosen to use to ensure that multi-national corporations pay a fair share of state taxes commensurate with the services they receive. It would be unfair to those states to shift the tax burden to domestically operated large and small businesses to pay for services provided multi-nationals.

One benefit of our federal system is the ability of states to operate as laboratories for new programs and methods. The state experimentation with the unitary method serves as a useful example of how one taxing method works, and provides information to the federal government and state governments on whether this method can improve revenue bases by enhancing tax compliance.

Essentially, the type and method of taxation a state uses under our federal system is a local question, provided it meets constitutional muster. The unitary method has met all constitutional challenges, including allegations that its use prevents the United States from speaking with one voice in foreign policy matters. Since the question of its use is strictly a local matter, there should be no federal interference through preemption.

In 1983 President Reagan had then Secretary of the Treasury Donald Regan established a Working Group on World-Wide Unitary Taxation. Governors Deukmejian, Thompson, and Matheson represented the National Governors' Association along with representatives of state legislatures and state tax officials. The Working Group agreed to a report which called for voluntary state action to modify state laws in return for federal assistance in state taxation of multi-national corporations.

Since then, of the 14 states which have utilized world-wide unitary, only 3 states still do - Alaska, Minnesota, and North Dakota. Forty-seven states do not. California, the largest state user, does not. Whatever concerns the Administration, multi-national corporations and foreign governments may have had, are dissipating. Even Minnesota and North Dakota are likely to recede from world-wide unitary to "waters edge" unitary by the end of next year.

Only Alaska is likely to continue to use the method because its use is supported by the major multi-national corporations doing business in that state.

The only outstanding state-related issues covered by the proposed legislation are whether so-called 80/20 corporations should be included within the definition of waters-edge and what level of state taxation of foreign source dividends is acceptable. Neither question has foreign policy ramifications; neither question could be resolved by the Working Group. Since the resolution of these issues is strictly of domestic concern, there is no reason for the federal government to be involved. They are strictly state questions.

Federal Assistance

As part of the Working Group agreement, the Administration indicated it would provide federal assistance to state tax compliance efforts in return for state modification of world-wide unitary laws to waters-edge. Only 3 of 14 states that used the world-wide method do so now, but the promised federal assistance has not been realized. We urge the Committee to work with the Administration and other appropriate Congressional Committees to authorize disclosure of taxpayer information to states, renegotiate tax treaties, enhance IRS capabilities and provide appropriate IRS training and cooperative efforts.

In summary, there is no reason for federal preemption, but there is reason for the federal government to stand by its commitment to states to enhance their compliance tools so multi-national corporations will continue to pay their fair share of state corporate income taxes.

NATIONAL
FARMERS
UNION

TESTIMONY OF ROBERT A. DENMAN, LEGISLATIVE ASSISTANT FOR THE NATIONAL FARMERS UNION BEFORE THE U.S. SENATE COMMITTEE ON FINANCE, SEPTEMBER 29, 1986.

Mr. Chairman, I am Robert A. Denman, Legislative Assistant for the National Farmers Union (NFU), a family farm organization representing some 250 thousand family farms in the Nation.

The National Farmers Union has long been on record in support of the unitary method of calculating the taxable income of multinational corporations. We testified before the House Ways and Means Committee in 1980 in opposition to legislation similar to S. 1974, the subject of today's hearing. In the 1982 Supreme Court case of the Container Corporation of America v. the California Franchise Tax Board, the NFU filed an Amicus Curiae brief in support of the Franchise Tax Board noting that "invalidation of the California tax would result in discriminatory treatment based solely on geographic considerations." We argued then and continue to hold that fairness to state and local taxpayers requires that those engaged in interstate and foreign commerce pay a fair share of the burdens of government.

I come before you today because we believe that should federal legislation restricting state taxation of multinational corporations be enacted, it would pose a threat to American farmers because: 1) It would subsidize foreign investment in U.S. farmland by sheltering the profits of foreign investors from effective state taxation; 2) It would encourage the restructuring of corporations so that the bulk of their American profits could be attributed on paper for tax purposes of foreign subsidiaries or associates; 3) It would result in a severe loss of revenue to State governments, tending to shift the tax burden to the real property tax base, already sorely overtaxed.

The tax climate of the U.S. is already tilted in favor of foreign investors in the U.S., and in favor of the flight of capital of the nation's corporations into foreign investment, both trends being motivated by the prospect of tax avoidance. More American farmland has come under foreign ownership since 1977 than in the past fifty years. Fifty-four percent of all farm land parcels owned or controlled by alien investors have been acquired since 1975. We are not contending that all investment by U.S. companies in foreign plants and subsidiaries or all investment by foreign companies in American plants and subsidiaries is undesirable. But, we do question such investment where its principle motivation is tax avoidance.

United States tax policy, in our view, must recognize the economic self-interest of the United States. If, due to federal legislation, the unitary method of computing taxable income were to be disallowed, this would shift a substantial annual tax load, estimated in the hundreds of millions of dollars annually, from the foreign persons and corporations to state and local taxpayers. Since state sales and income levies are already at what many regard as scarcely tolerable levels, the tendency would be for the revenue lost by the states to be sought largely from the property tax base. In many states, agricultural land is an important part of that tax base. In contrast, the tax burden imposed on the multinational corporations by the U.S. federal government and the several states is relatively light.

A decision of this body to bar the use of the unitary apportionment system would have the effect of acquiescing in discrimination in favor of multinational corporations to the detriment of domestic corporations. It would interfere with the rights of the states to tax income which is earned, in part, in their respective states and also lead, undoubtedly, to a restructuring of business activity in order to avoid state taxes.

Such a decision would encourage multinational corporations to engage in a tax "shell game", to assign their profits to jurisdictions which allow them to avoid or minimize tax liability. The opportunity to attribute U.S. corporate profits on paper to foreign subsidiaries or associates should not be encouraged by this body.

Our policy statement on this issue continues as follows, "At a time when the federal government is turning responsibility for programs to the states, actions should not be taken which would impair the state tax bases or provide tax loopholes for multinational corporations."

Thank you Mr. Chairman for your time and consideration.

New Mexico
TAXATION & REVENUE DEPARTMENT
P.O. Box 630, Santa Fe, New Mexico 87509-0630

September 3, 1986

Betty Scott-Boom
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Ms. Scott-Boom:

We are submitting a statement for inclusion in the record of the hearing to be held September 19 by the Subcommittee on Taxation and Debt Management on Senate Bills 1113 and 1974, restricting use of the worldwide unitary method. The statement, and five copies, are enclosed.

Sincerely,

Vickie L. Fisher
Secretary

VLF/ml

Enclosure

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STATEMENT OF VICKIE L. FISHER
SECRETARY OF TAXATION AND REVENUE
STATE OF NEW MEXICO

REGARDING S. 1113 AND S. 1974

State treatment of foreign-source income and expenses for state income tax purposes has been an issue for at least a quarter century. Over the years the arguments have not changed much, though the noise level certainly has increased. It is probably time to put this issue to rest.

The fundamental question now is not so much what the solution is but rather how it is to be implemented. Must the federal government promulgate yet another edict mandating that the states behave in certain ways? Or is this a problem that the states can and will resolve by themselves?

We submit that there is good evidence that the states are moving to a resolution. New Mexico, for example, formerly permitted (but did not require) corporate groups to file on a worldwide unitary basis. In 1983 our statutes were amended to prohibit use of this method. Since then many other states have eliminated or restricted use of this technique. Action is pending in at least one of the few remaining states still applying this method.

With a little more patience, Congress may find that the "problem" has vanished. We urge this patience.

Regarding S. 1974 in particular, we note only that it is one of the few bills offered in Congress on this topic that at least offers substantial federal cooperation and assistance to the states. For that alone, the sponsor and the Administration are to be complimented, though this bill too ought to be put on the shelf for awhile.

National Conference of State Legislatures

444 North Capitol Street, N.W.
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202/624-5400

President David E. Nething
Majority Leader
North Dakota Senate

Executive Director
Earl S. Mackey

STATEMENT OF THE

HONORABLE DAVID E. NETHING

MAJORITY LEADER, NORTH DAKOTA SENATE

PRESIDENT, NATIONAL CONFERENCE OF STATE LEGISLATURES

SUBMITTED TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITEE ON FINANCE

WORLDWIDE UNITARY TAXATION

SEPTEMBER 29, 1986

Denver Office: 1050 17th Street • Suite 2100 • Denver, Colorado 80265 • 303/623-7800

I am Senator David Nething, President of the National Conference of State Legislatures, on whose behalf I present this statement.

As a member of the Worldwide Unitary Taxation Working Group, I was a signatory of the Final Report submitted by then Treasury Secretary Donald T. Regan, to President Ronald Reagan in August 1984. One of the three agreed principles of that Report was that the change from worldwide unitary taxation to waters edge unitary "would be implemented by state action rather than Federal restrictions." Final Report, p. 9. I have carefully followed the progress of this issue since that recommendation was made. As Majority Leader of the North Dakota Senate, I know that our state legislature is currently proposing changes that will bring us from the worldwide unitary method of taxation to the water's edge.

NCSL POSITION

The National Conference of State Legislatures represents the 50 state legislatures across the country. State legislatures have a mandatory responsibility to determine state revenue needs to balance appropriations for essential programs. This responsibility has increased in its challenge due to declining Federal assistance. One method of ensuring adequate state revenue has been to take steps to assure the correct apportionment of corporate taxes to each state.

Several states worked to lessen the possibilities of tax avoidance available through traditional "separate accounting" by instituting a new method of apportionment of taxation that accounted for worldwide sales, property and payroll of a unitary business.

Many states have since reconsidered worldwide unitary in light of the recommendations of the Working Group and interstate competitiveness. Today all but three states -- North Dakota, Montana and Alaska -- have adopted legislation repealing worldwide unitary taxation. The Working Group Report called for increased Federal cooperation with the states to promote taxpayer disclosure and accountability as a condition for the states limiting unitary combination to the water's edge. Without waiting for the Federal assistance states have acted on the recommendations of the Working Group. In spite of this effort by states that had previously adopted worldwide unitary taxation, Senate bill S. 1974 imposes restrictions on all states.

The NCSL supports measures taken at the Federal level that would include: (1) training state auditors and tax administrators on international tax matters; (2) developing procedures for states to trigger Federal audits under reasonable circumstances; (3) supporting of audit referral staff to review domestic spread sheets for inconsistencies; and (4) establishing a study to improve the separate accounting method. NCSL opposes any Federal legislation that interferes in state taxation of foreign source dividends or the income of foreign subsidiaries, and therefore opposes any such restrictions as found in S. 1974.

In order to achieve a fair allocation of the tax burden between corporations with multinational ties and corporations without multinational ties, the Federal government must assist states as they move away from worldwide unitary taxation.

The NCSL supports the provisions of S. 1974 that implement sections of the Working Group Report requiring the sharing of Internal Revenue Service information among the qualified states, and the filing of domestic spreadsheets. In addition, NCSL supports better international enforcement by the introduction of steps to increase the productivity of the international tax examiner office of the Internal Revenue Service. These measures would necessarily make worldwide unitary taxation less appealing to states that have not yet repealed it, and would correct some of the abuses that have occurred through the separate accounting method of income reporting.

COMPLAINTS ABOUT METHODS OF ACCOUNTING

The complexity of the problem of taxation of multijurisdictional corporations is highlighted by the "Issues" stated in Section 3 of the Final Report of the Working Group. All but one of the concerns of critics of worldwide unitary echoed similar concerns of critics of separate accounting. Each system drew criticism for the following reasons: (1) inaccurate income measure; (2) limited access to necessary information; (3) income distortion for foreign-based multinationals; (4) administrative complexity; (5) taxpayer uncertainty; (for example, "unitary business" definition vs. "arm's length" prices); (6) method not internationally accepted; (7) criticism by General Accounting Office. With so much in debate, the matter should be left to the states.

In meeting the criticisms of worldwide unitary taxation the U.S. Supreme Court dismissed the difficulties of defining a unitary business and the necessary imperfections of the three-factor formula apportionment as inadequate reasons to set aside this method for states to determine fair taxation of multi-jurisdictional corporations. The Supreme Court termed the unitary taxation method as "proper and fair." Container Corp. of America vs. Franchise Tax Board, 463 U.S. 159, 184 (1983).

THE FOREIGN PROBLEM

One distinct concern of the critics of worldwide unitary is the reaction of foreign businesses and governments. However, after examining the unitary method of taxation in the context of the Foreign Commerce Clause, the Supreme Court concluded that "such taxation is in reality of local rather than international concern." Id. at 196. The thorough analysis by the Court focused on the questions of enhanced risk of multiple taxation and the need for national uniformity. Id. at 185, 186. The Court concluded that under the unitary method, neither the possible overlapping of taxes nor the "risk of retaliation" was sufficient to conclude that the uniform method was either "pre-empted by federal law or fatally inconsistent with federal policy." Id. at 197.

Although there are other areas where serious harm might result to the national interest if the national government did not speak with one voice, the speculation about how a state might impose a method of taxation in the future should not be grounds to impose national restrictions upon the states in matters relating to state tax policy.

Those countries and companies who question the fairness of the worldwide unitary method of taxation because of its supposed uneven treatment of multinational corporations appear less than concerned about state-implemented policies that result in uneven tax breaks or tax incentives for the location of multinational business within the various states. Just as competition among the states has resulted in tax expenditures for various multinational corporations, so also competition among the states may lead to the elimination voluntarily of the worldwide unitary method of taxation. Certainly that is the trend. In short, Congress should not threaten long-standing deference to state tax policy in order to achieve a limited and questionable goal.

CONCLUSION

NCSL urges that the option to repeal worldwide unitary taxation remain at the state level and that the Federal government implement only legislation that is intended to assist the states in taxing multinational corporations fairly by preventing the avoidance of state taxation.

NATIONAL FOREIGN TRADE COUNCIL, INC.
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Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

September 29, 1986
Hearings on S.1974 and S.1113
Bills that Prohibit the Imposition by States of the
Worldwide Unitary Method of Taxation

Statement for Inclusion in the Printed Record of Hearings

Submitted by:
National Foreign Trade Council, Inc.

Thomas J. DuBos
Chairman, Tax Committee

WASHINGTON OFFICE: 900 17TH STREET, N.W. • WASHINGTON, DC 20006 • (202) 887-0278

The National Foreign Trade Council is a non-profit association of more than 500 U.S. companies who are engaged in all aspects of international trade and investment.

The Council supports the passage of Federal legislation which prohibits the application by any state of the worldwide unitary method of taxation and provides for the equitable tax treatment by states of foreign source income, including dividends.

In his letter of March 5, 1986 to Chairman Packwood, Treasury Secretary Baker documented the reasons why he believes this kind of legislation is necessary. Without going into too much detail, we believe the legislation is needed for the following reasons:

(1) Under the worldwide method, a share of the worldwide income of a group is apportioned to a state by reference to a formula; the relative factors in the formula are sales, property and payroll. This formula apportions income inaccurately; it cannot help but do so since the factors do not produce the same amount of income in each location where they are employed. The fact is they produce widely different amounts of income in different places.

The fallacious theoretical rationale under the worldwide unitary method is that the highest amount of income is earned where the highest costs are incurred. Obviously, the opposite is usually true. Intrinsic payroll costs and property values vary widely around the globe, with the variances in the factors being widened or narrowed by swings in extrinsic exchange rates. These factors have tended and still tend to be relatively high in the U.S. Thus, the worldwide unitary method works to overallocate income to the states that use that method.

(2) The worldwide formula method conflicts with the Federal and internationally accepted practice of allocating income by reference to the separate accounting method; under the separate accounting method income is traced and assigned to the location where it is actually earned. The OECD specifically considered and rejected the unitary method; to the best of our knowledge, outside the applicable states, the method is used by no other governing body in the world.

(3) This difference in methods of accounting for income leads to its double taxation and to added layers of burdensome compliance expense. These added costs are extremely onerous, so much so that involved foreign countries have petitioned for curbs on the states' use of the worldwide unitary method and domestic companies have complained about the taxation by states of income earned outside the U.S.

(4) The worldwide unitary method lends itself to being administered in a arbitrary manner in order to maximize revenue. The concept of a combinable unitary business is in many cases nebulous. Thus, out-of-state operations may be viewed as combinable or not depending upon whether those operations are profitable or not, and upon the judgement of the particular tax examiner. As a result, competitive companies in similar economic circumstances may very well have different tax bills.

In his letter, the Treasury Secretary outlines the 3 principles agreed to by the Administration-sponsored working group as being those that must be present in any resolution of this problem. The group was composed of the Federal government, state governments and the business community. The 3 principles are:

1) A water's edge method of allocation -- for both U.S. and foreign multinationals -- be provided instead of or in lieu of the worldwide method

2) Federal assistance to states on taxpayer disclosure

3) Competitive balance for U.S. and foreign multinationals.

Federal legislation would certainly satisfy these three principles. The only question is whether it is needed now that California, by far the most important impacted state, has taken steps to make its worldwide method elective and to reduce its tax on foreign-source dividends.

The answer to that question is an emphatic yes; federal legislation is still needed. First, Federal legislation is needed in any case because the problem is a federal and international problem that requires a federal and not a state solution. Additionally, a federal solution is needed because the California law does not satisfy the 3-principle solution, since it violates two of the principles.

A federal solution is required in any case because without it there is nothing to prevent the problem from arising again, if and when afterwards states reimpose the worldwide method. If the states do that, they again would be interfering with the foreign commerce policy of the Federal government. The U.S. must not again be put in that kind of position. It must be able to speak with one voice in that area and not only at the time it speaks but also at all later times, unless it - not a state - wishes to change the message.

A federal solution is also required because California law is deficient. It is deficient since: (1) it requires that an annual ransom in the form of a fee be paid to opt out of the worldwide method; (2) it contains so many escape clauses for the state that taxpayers cannot be assured that their election to opt out of the worldwide method will actually be eventually allowed; (3) it does not provide for a competitive balance, since U.S. multinationals are subject to tax on part of their foreign dividends. Foreign multinationals do not pay tax on such dividends; (4) it includes sub-part F income in the base and 80/20 companies in the consolidated group; and (5) it does not take effect until 1988.

Accordingly, the Council feels Federal legislation is needed and that it is needed now. Otherwise, if left over to the next session, this intrinsically important legislation could very well fall victim to inertia or to then current political exigencies.

Incidentally, for its high value as source material, filed with this testimony is a copy of the Treasury Secretary's letter of March 5, 1986 to Chairman Packwood. In our opinion, the letter provides a clear and logical dissertation on all the historical and technical background to the subject that is required.

#

September 29, 1986

THE SECRETARY OF THE TREASURY
WASHINGTON

March 5, 1986

Bob

Dear ~~Mr. Chairman~~:

S. 1974, introduced by Senator Wilson, as well as Senators Mathias and Hawkins, in the Senate on December 18, 1985, would generally prohibit states from levying corporate income taxes on a worldwide unitary basis. This legislation falls within the jurisdiction of the Senate Finance Committee. The bill was drafted by the Treasury Department at the express direction of the President and has the full support of the Administration. I have attached for your consideration a copy of the President's statement of November 8, 1985 on the worldwide unitary tax issue, directing me to prepare and submit this legislation to Congress. A technical explanation of the bill, providing a complete description of its provisions, is also enclosed. This letter is intended to provide you with background on the worldwide unitary tax issue and to describe the serious concerns that have led the Administration to propose and support this legislation.

I. Description of Current State Corporate Income Tax Practice

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are in use for making this determination: separate accounting and worldwide unitary combination.

Separate accounting is the method of taxation in use generally throughout the world and is employed by the federal government. Under separate accounting, taxable income is determined separately for each individual corporation. Any improper income or profit shifting between related corporations for tax avoidance purposes is corrected by requiring "arm's length" pricing in related party transactions. That is, flows of goods and services between related or commonly-owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length. Under the separate accounting method, double taxation between jurisdictions is relieved either through exemption from tax by the residence jurisdiction (usually the place of incorporation or management control) of income derived in the source jurisdiction (the place the income is earned), or by the residence jurisdiction granting a credit for taxes paid to the source jurisdiction. The United States federal tax law uses the latter approach.

The alternative method, worldwide unitary combination, is currently used by seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah*) to determine a multinational enterprise's state corporate tax liability. Under this approach, the business income of all individual companies in the commonly controlled enterprise which operate in the same general line of business (the "unitary business") as the corporation or corporations subject to the state's taxing jurisdiction is aggregated, regardless of (i) whether the other individual companies are foreign or domestic; (ii) whether the other individual companies have a tax nexus with or presence in the state in question; and (iii) whether the income of the other individual companies would be treated as derived from foreign or domestic sources under federal tax rules or generally accepted international taxation principles. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of a formula which is intended to measure how much of the activity of the unitary business (and hence its income) is attributable to the taxing jurisdiction.

The apportionment formula generally used is based on relative amounts of payroll, property, and sales. If, for example, 25 percent of the payroll, property, and sales of the unitary group is located in the taxing jurisdiction, then 25 percent of the group's aggregate income from the unitary business would be apportioned to that state. Because the apportionment formula is considered to assign the appropriate amount of income to a particular state, no further measures are taken to relieve any multiple taxation of the same income which may arise from the use of different income sourcing rules by other taxing jurisdictions.

Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transfers. Under separate accounting, in contrast, intercorporate dividends are recognized explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A "water's edge" limitation on the unitary method, i.e., excluding foreign corporations, would respect the separate entity status of related domestic and foreign corporations. It therefore gives rise to the question of how dividends received by a U.S. corporation that is a member of a "water's edge" unitary group from a foreign corporation that is not a member of the "water's edge" group should be treated for state tax purposes. The question of state taxation of foreign-source dividends is thus inextricably linked to the issue of worldwide unitary taxation and, as described below, is therefore addressed in the proposed legislation.

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* Utah has adopted administrative rules that would abandon worldwide unitary taxation upon implementation of certain federal assistance measures, including the enactment of the federal assistance legislation contained in the proposed bill and described in section IV, below.

Under present law, state taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. Though dividends from a domestic corporation are subject to tax in nearly all states with a corporate income tax, most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is largely to exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation (and thus taxation) to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

II. Reasons for Administration Opposition to Worldwide Unitary Taxation

It has been the longstanding policy of the United States to favor the separate accounting method for allocating income among nations for purposes of taxation. This policy is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. The model tax treaties published by the Organization for Economic Cooperation and Development ("OECD") and the United Nations ("UN") specify that transnational income is to be taxed on a separate accounting basis. Thus, continued state worldwide unitary taxation is directly in conflict with federal and internationally accepted practice and impedes the ability of the federal government to pursue this policy in its international dealings.

During the debate over worldwide unitary taxation, foreign governments have repeatedly petitioned the federal government to act to curb state use of the worldwide unitary method. Diplomatic notes articulating the problems caused by state worldwide unitary taxation have been received from virtually every developed country in the world, including Canada, the United Kingdom, Germany, France, Belgium, the Netherlands, Italy, Switzerland, Japan, and Australia. The United Kingdom, in July, 1985, adopted anti-unitary retaliatory legislation that would permit the U.K. government to effectively increase the U.K. tax on dividend distributions from U.K. subsidiaries to their U.S. parent corporations operating in worldwide unitary states. If implemented, this legislation would clearly violate the U.S.-U.K. bilateral income tax treaty. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having an adverse effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States. (The U.K. has now agreed to defer implementation of this legislation for the time being.) The adoption of this legislation by the U.K. illustrates that state worldwide unitary taxation is clearly adversely affecting the United States' foreign economic relations.

Foreign governments and businesses that are subject to worldwide unitary taxation argue that this method of computing state tax gives rise to double taxation of foreign income. They also contend that worldwide unitary taxation is administratively burdensome, particularly for foreign owned companies. These results are inevitable as long as a few states rely on a method of measuring income that is different from the approach used by the rest of the world.

Theoretically, if all jurisdictions, domestic and foreign, were to adopt a uniform unitary method of taxation, and apply it consistently, there would be no double taxation as the formula would not apportion the same income to more than one jurisdiction. The problem, however, arises from the fact that combined reporting on a worldwide unitary basis is a distinctly minority practice. In an environment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs, property values, and profitability can vary greatly among countries, an income measurement system based on formula apportionment is in open conflict with the international standard of separate accounting. This is because formula apportionment assumes all parts of a unitary business are equally profitable whereas separate accounting acknowledges that individual corporations can earn different rates of return. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis.

State use of the worldwide unitary method also creates administrative burdens for taxpayers. There are substantial costs associated with collecting and converting accounting data generated by the various foreign affiliates of the unitary group to a form consistent with U.S. standards. These burdens can be particularly acute for foreign-owned companies which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other purpose.

The use of the worldwide unitary method by some states may also inhibit and distort the international flow of investment capital. In the words of one foreign government, "[t]he [unitary tax] method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." Consequently, according to a group of foreign governments, worldwide unitary tax constitutes "...a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). The United States is strongly committed to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer. Some states may be in a position in which their use of the unitary method causes foreign investors to turn away from the United States altogether (rather than shift investments to other U.S. states).

In September 1983, in response to complaints raised by both the U.S. and foreign business community and foreign governments over the Supreme Court decision in Container Corp. v. Franchise Tax Board, President Reagan asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group. This group was composed of representatives of the federal government, state governments, and the business community and was asked to provide recommendations suitable for resolving the issues raised by worldwide unitary taxation.

At its final meeting on May 1, 1984, the Worldwide Unitary Taxation Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

Principle 1: "Water's edge" unitary combination for both U.S.- and foreign-based companies.

Principle 2: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle 3: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

While the first and third principles were to be adopted voluntarily on a state-by-state basis, Principle 1, in particular, represented a clear recognition by the Working Group that the separate accounting method was superior to the worldwide unitary method in the international context. The Administration was very hopeful that the states would be able to resolve the worldwide unitary problem along the lines advocated by the Working Group on a voluntary basis without resort to federal legislative intervention.

Since the adoption of the Working Group Report some states have changed their laws to conform to the Working Group principles. Florida, Colorado, Indiana and Oregon have ceased taxing on a worldwide unitary basis. A Massachusetts court decision imposed limitations on that state's use of the worldwide unitary method and the state legislature has to date refrained from taking any action that would permit application of that method in the face of the judicial decision. However, seven other states continue to use the worldwide unitary method. In particular, efforts in California to enact legislation limiting worldwide unitary taxation have foundered in the past two legislative sessions, most recently when the California legislature adjourned for the year in September, 1985 without taking action on the issue.

In transmitting the report of the Working Group to the President, Secretary Regan indicated that he would recommend restrictive federal legislation if substantial voluntary progress had not been made on the worldwide unitary issue at the state level by July 31, 1985. That date has long since passed. We now believe that the time has come for Congress to act to finally resolve this serious international economic problem.

III. State Taxation of Foreign-Source Dividends

The taxation of foreign-source dividends is directly related to the issue of worldwide unitary taxation. A limited resolution of the worldwide unitary issue -- such as an agreement by states not to impose worldwide unitary tax but with no restriction on the taxation of foreign-source intercorporate dividends -- would cause other serious problems. In effect, this would be a "foreign only" situation, freeing foreign-owned multinationals from the yoke of worldwide unitary taxation while subjecting U.S. based multinationals to full taxation on their foreign dividend income. Such a "foreign only" solution, if adopted, would disadvantage domestically controlled businesses. The Working Group's third principle recognizes the need for competitive balance for domestic multinationals, foreign multinationals, and purely domestic businesses. That principle requires that legislation restricting state unitary taxation also address the question of equitable state taxation of foreign-source dividends. Unrelieved state taxation of foreign dividends is not consistent with Principle 3.

Unrestricted state taxation of foreign dividends would subject domestic businesses to serious double taxation of foreign income. Federal tax policy has long been characterized by its commitment to avoid international double taxation. Indeed, the United States has been a leader in a worldwide effort to establish taxing rules under treaties and commonly accepted principles that minimize international double taxation. If a clear federal policy is not to be undercut by state action, states must comply with this policy of eliminating double taxation and therefore be limited to taxing some equitable portion of foreign source dividends.

The legislation does not mandate that any specific method of dividend taxation be imposed on the states. In our view, arguments of state fiscal sovereignty strongly indicate that states should have leeway to tailor their own systems of taxation to the extent that they do not cause serious foreign commerce difficulties by resulting in systematic overtaxation and double taxation of U.S. business in contravention of established federal and international policy. The legislation therefore provides in broad terms for the equitable taxation of dividends and suggests certain guidelines that states could follow in satisfying that standard. As an illustration of the flexibility of the approach, the legislation would accept as appropriate the treatment of dividends in such states as Colorado, Oregon, Florida and Illinois, states which have been intimately involved in the worldwide unitary tax controversy.

IV. Information Reporting and Other Federal Assistance

States have legitimately contended in the Working Group and elsewhere that they lack the resources and ability to monitor adequately transactions between members of a water's edge unitary group and related foreign companies outside that group. The Treasury Department agreed with recommendations of the Working Group to provide appropriate federal assistance to the states in order to assure proper working of the separate accounting method. The Working Group suggested that an annual information return be filed with the Internal Revenue Service by multinational companies. This return would in turn be shared with the states and with multistate audit agencies and would provide states with some assurance that corporations had allocated and apportioned the appropriate share of the corporation's income to each state. The report would also identify those related companies with which serious income shifting would be most likely to arise. In the summer of 1985, the Treasury Department published for comment a draft of legislation implementing this reporting system. Section 3 of the bill is based upon that draft after taking into account the many comments received from affected businesses and the various states. We believe that the information reporting system provided for in the bill is an integral part of the solution to the worldwide unitary problem.

In order to provide states with greater assistance the Treasury Department also indicated in the Working Group an intention to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. I urge your assistance in approving the increased budget appropriations that are being requested for this purpose.

Conclusion

I strongly urge the prompt and favorable consideration of this legislation by the Finance Committee. The serious foreign commerce difficulties caused by the use of the worldwide unitary tax method by a few states must now be resolved.

OMB has advised that there is no objection from the standpoint of the Administration's program to the presentation of this legislation to the Congress and that its enactment would be in accord with the program of the President.

Sincerely,

Jim

James A. Baker, III

The Honorable Bob Packwood
Chairman, Finance Committee
United States Senate
Washington, D.C. 20510

Royal Netherlands Embassy.

11518

Washington D.C.
September 26, 1986.

The Honorable Bob Packwood
Chairman,
Senate Finance Committee
U.S. Senate
S.D. 219 Dirksen Senate Office Building
Washington D.C. 20510

Dear Senator Packwood,

On the occasion of the Hearings of your Committee on worldwide Unitary Taxation (S 1974 and S 1113) I have the honor to submit the following comments on behalf of the Netherlands Government:

1). The Netherlands Government has noted recent developments in California, and in particular the adoption of legislation limiting the application of worldwide Unitary Taxation in that state.

2). The Netherlands Government nevertheless persists in strongly supporting federal legislation in this matter for a number of reasons:
   a) such legislation would provide clarity, certainty, and legal security for foreign business enterprises operating in the United States with regard to their liabilities in all states of this country.
   b) such legislation would diminish the possibilities of a return to outright Unitary Taxation on worldwide basis.
   c) such legislation would not link "water's edge" treatment to conditions not related to taxation such as election fees.

3). Appended is a letter from State Secretary Koning of May 26, 1986, in which he underlines the importance The Netherlands attaches to federal legislation on this matter, and provides further comments on the proposed legislation before you.

Sincerely yours,

Fein

Richard H. Fein,
Ambassador of The Netherlands.

The Hague, 26th May 1986

The Honourable Bob Packwood
Chairman of the Senate Finance Committee
U.S. Senate, Capitol Hill
Washington DC
The United States of America

Nr. 086-809

The proposed unitary
tax legislation.

Dear Senator Packwood,

As State Secretary of Finance of the Netherlands, I would like to draw your attention to the unitary tax legislation introduced into Congress by the federal Government on 18 december 1985.
The Netherlands Government has many times expressed its concern about the application of worldwide unitary taxation by several U.S. states. In this context I would like to refer to the memorandum signed by 16 OECD member countries and the Commission of the European Economic Community on 2 May 1986, which was recently sent to you.
Now that the states applying worldwide unitary taxation have not been able to deal satisfactorily with the issue, I welcome the introduction of a federal bill restricting the states' use of unitary taxation, thus enabling the United States to speak with one voice on this subject.
This bill may be an important step toward solving this long-standing problem.
I would, however, like to ask your attention for a few points in the bill which in my view are not satisfactory.

With respect to the description of the so-called water's edge limitation (section 7518, letter c, (2), I would like to reiterate the view of the Netherlands and virtually all member countries of the OECD that the internationally accepted principle of separate accounting and at arm's length pricing ought to be adhered to. This principle implies that the application of unitary taxation should be limited to U.S. companies, including U.S. subsidiaries of foreign companies, and the permanent establishments of foreign companies operating in the U.S.
The profits of these permanent establishments (a notion well defined in the OECD model double taxation convention, and in the tax treaties concluded by the federal Government) ought then be determined on the basis of their accounts, where appropriate adjusted on an arm's length basis, and not - as under the unitary method - by applying a formula to the head office's profits.

- In -

In this respect there is concern over:

- section 7518 (c) (2) (D) which contrary to the aforementioned principles, includes foreign corporations if a certain level of activities is exceeded in the U.S., even though there may not be a permanent establishment in the U.S. at all. I would advocate to treat domestic branches of all foreign corporations as a separate entity. In the bill (section 7518 (c) (6)) this approach is only applied to certain bank branches, whereas in other cases the Secretary of the Treasury m issue regulations to that effect.
  The approach I advocated, also solves a matter not clearly dealt with in the bill that is the taxation of domestic branches of foreign corporations not exceeding the threshold level of activities mentioned in the bill. Without such a provision the bill does not seem very clear on whether or not those branches might be taxe on an apportioned part of the profits of their foreign head offices.
  If they might be, it could become unattractive for foreign corporations to start innovative investment in the U.S. Due to the risks involved in such investment, corporations often prefer to make such investment through branches. In that case they can immediately set off (initial) losses in their home country. If, however such a loss making branch could be taxed in a state on an apportioned part of its head office's profits, it is clear that the double taxation resulting therefrom may hamper innovative risk bearing investment in the U.S.
- section 7518 (c) (2) (E) and 7518 (c) (3) (C). In these subsections certain (tax haven) companies are included in the water's edge group. This approach might be acceptable if it is ensured that the wording "not subject to substantial tax" is defined in such a way that no major U.S. trading partners, like the Netherlands may be affected by the provision.

With respect to the possibility of the states to retain worldwide unitary taxation in spite of the above discussed water's edge limitation, I would like to submit t following remarks.
In Section 7518, letter a, the use of worldwide unitary taxation is still permitt to the states if the taxpayer, inter alia, fails to comply with legal or procedur requirements of the income tax law of a state, or if neither the taxpayer nor th Government of the relevant foreign country provides to a state, within a reasona period after proper request, material information relating to the determination the income of the taxpayer,
The Netherlands takes the view that it does not seem appropriate to introduce an internationally rejected method of taxation like worldwide unitary taxation as punishment for failure to comply with requirements, this appears especially so s section 6039A (e) of the bill already allows to impose proper penalties.

Finally section 6039 A (reporting requirements) seems to impose a considerable administrative burden on the companies concerned. I trust that the Netherlands b multinationals will, where they consider this necessary, further comment on tha section to you, either in writing or orally during the hearings to be held bill in Congress.

I hope the points mentioned above will be addressed in the discussions in Congress, and would greatly appreciate if these points could be dealt with in the final legislation. A satisfactory solution of this issue will certainly enhance the further development of economic relations between our countries.

H.E. Koning

EMBASSY OF SWITZERLAND

October 10, 1986

Dear Senator Packwood:

The Government of Switzerland appreciates the opportunity to submit comments on S.1974, the proposed Unitary Tax Repealer Act. In a letter to you dated April 29, 1986, Switzerland, along with fifteen other countries and the Commission of the European Communities, expressed its concern that the use of the worldwide unitary method of taxation by certain states represents a serious divergence from the long-established principles of international corporate taxation and a deterrent to the further development of the investment and trade relationship between Switzerland and the United States. We commend the efforts of the Administration to resolve the problems caused by the worldwide unitary method of taxation, and the efforts of the Senate Finance Committee in considering S.1974. Although California has recently enacted unitary return legislation, we believe the need for a Federal solution to the problem remains. We find serious deficiencies in the California legislation; and Alaska, Montana and North Dakota continue to use the worldwide unitary method of taxation.

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
Dirksen Senate Office Building, SD-219
Washington, D.C. 20510

We believe that S.1974 presents an appropriate framework for a Federal solution to the problem of worldwide unitary taxation. We have, however, misgivings regarding certain aspects of the Bill, which we raise in our comments.

Respectfully submitted,
in the absence
of Ambassador Jacobi

David de Pury
Minister
(Deputy Chief of Mission)
Embassy of Switzerland

cc: The Honorable John M. Chafee
Chairman, Senate Subcommittee on Taxation
and Debt Management, United States Senate

The Honorable Charles Mc C. Mathias, Jr.
United States Senate

The Honorable Pete Wilson
United States Senate

The Honorable Dan Rostenkowski
Chairman, Committee on Ways and
Means of the House of Representatives

The Honorable J. Roger Mentz
Assistant Secretary for Tax Policy,
Department of the Treasury

The Honorable Douglas Mc Minn
Assistant Secretary for Economic and Business Affairs
Department of State

The Federal Role in the Unitary Tax Debate

Statement prepared for Senate Finance Committee Hearings

Steven M. Sheffrin
Professor and Chair
Department of Economics
University of California, Davis

In his letter of July 31, 1984, conveying the report of the Working Group on Worldwide Unitary Taxation to the President, Secretary of Treasury Donald Reagan anticipated that the states would conform their practices to those recommended by the Working Group and thereby avoid the need for federal legislation. By September of this year, most of the states that utilized worldwide combination have, in fact, changed their laws to conform to the recommendations of the Working Group and the few states that remain will most likely change their laws in the near future. At this point, there is really no need for federal legislation.

California is the most recent state to change its laws governing the taxation of the multinational corporations. After long and extended negotiations in which foreign and domestic interests were represented, California adopted a system in which corporations can choose to be taxed on a water's edge basis. Any corporation choosing this method must stay with this accounting scheme for ten years and contribute to an infrastructure fund based on its payroll, property and sales in California. Domestic multinationals are essentially allowed a seventy-five percent exclusion of dividends from foreign corporations in which they hold majority interests. Corporations, moreover, can continue to file under worldwide combination if they find that option preferable.

The primary accomplishment of the California legislation is to remove any serious grounds for complaint by foreign-headquartered multinationals. Any foreign-headquartered multinational with a United States subsidiary can now file on a separate accounting basis just as it does in its federal tax return. The small fee they must pay for this option (.03 percent on payroll, property and sales) can be easily justified as paying for the additional auditing costs which accompany separate accounting. No longer can foreign-headquartered multinationals complain that the unitary method is an impediment to trade. They can, if they wish, simply avoid unitary taxation by filing on a separate accounting basis.

At the same time, the negotiations in California arrived at a compromise that roughly balanced foreign and domestic interests. Two areas which will continue to be debated are the treatment of 80-20 corporations and the treatment of dividends from majority owned subsidiaries. In both cases, California adopted, in my view, a judicious approach.

80-20 corporations are domestic corporations which conduct most of their business (as measured by payroll and property) abroad. California included them in the waters' edge in their recent legislation. As the states argued in the Working Group report, there are special problems involved in auditing these corporations. Since they are domestic corporations, transactions between these corporations and the domestic parent are rarely audited on federal returns. If the states did not include them in the waters' edge, they would be forced to bear the full burden of auditing transactions between these corporations and their parents. The California legislation calls for a study, by March of 1987, of the auditing problems that would occur if the 80-20's were not included in the waters' edge. This study offers both the state and the corporations an opportunity to reexamine this issue. Pending this study, the approach taken by California is necessary in order to protect its interests.

With respect to dividends, California clearly adopted a position close proposed federal legislation. As the states argued in the Working Group report, dividends paid by foreign corporations to their parents are not necessarily "foreign source" dividends. Multinational corporations operate on a worldwide basis and often incur expenses in the United States which are deducted in their tax returns, which, in turn, lead to increased profitability abroad. Research and development expenses are only one important example of this type of transaction. Dividends thus represent a return on these investments. Since the costs of these investments are deducted in the United States, the returns on these investments should be taxed in the United States. The seventy-five percent dividend exclusion is an attempt to tax an appropriate share of these dividends without taxing income which is truly earned outside the state. It is in my view, a fair and quite reasonable policy.

The states have shown a willingness to adjust their tax policies in light of the issues raised in the Working Group. Although many tax administrators and policy experts prefer the unitary system, they have responded to the federal government's request to adjust their policies to accommodate the desires of some of our major trading partners. The legislation that has been adopted has been responsive and has cost the states significant revenue at a time when demands on states' coffers are high. With the primary foreign policy considerations eliminated by recent state legislative action, there is simply no justification for federal legislation. The remaining difficult and complex issues in state corporation taxation should be left to the states.

Statement

of

TAX EXECUTIVES INSTITUTE, INC.

on

Pending Federal Legislation Prohibiting State Taxation on the Worldwide Unitary Basis, Restricting the State Taxation of Foreign-Source Dividends, and Imposing New Information Reporting Requirements on Multistate and Multinational Corporations

September 17, 1986

I. BACKGROUND

Tax Executives Institute (TEI) is a professional association of corporate and other business executives who are responsible for the tax affairs of the companies by whom they are employed. Our 4,000 individual members represent more than 2,000 of the leading corporations in the United States and Canada.

Historically, TEI has been concerned with the administrative aspects of tax policy, and we are proud of our record of working with Congress, the Department of the Treasury, Internal Revenue Service, and appropriate state tax officials to reduce the costs and burdens of tax administration and compliance to the mutual benefit of government and taxpayers. TEI represents a true cross-section of the business community in North America -- including numerous non-U.S. owned or controlled multinational corporations. We believe our diversity and the professional training of our members enable us to bring an important and balanced perspective to issues such as those posed by federal legislation concerning the states' use of the worldwide unitary method: our members are the individuals who must contend with the applicable rules on a day-to-day basis.

TEI has long been interested in minimizing and rationalizing the administrative and fiscal burdens placed upon multijurisdictional businesses through the use of the worldwide unitary tax method. This statement sets forth TEI's position on pending federal legislation dealing with the worldwide unitary tax problem and related issues (S. 1974 and H.R. 3980).

II. SUMMARY OF PENDING FEDERAL LEGISLATION

On December 18, 1985, S. 1974 was introduced into the Senate and a companion bill, H.R. 3980, was introduced in the House of

Representatives. These bills attempt to resolve the worldwide unitary tax dispute and attendant problems in three principal ways.

First, the bills would prohibit states from using the worldwide unitary tax method to compute taxpayers' state income tax liabilities. Secondly, the proposed legislation would prohibit any state -- except the state in which a taxpayer has its commercial or legal domicile-- from taxing foreign-source dividends. Thirdly, the proposed legislation would impose new disclosure and information reporting requirements on certain multistate and multinational corporations.

III. THE NEED FOR FEDERAL LEGISLATION

The dispute over the constitutional propriety of the worldwide unitary tax method to compute the state tax liabilities of multinational businesses raged for over two decades and culminated in 1983 in the Supreme Court of the United States decision in Container Corporation of America v. Franchise Tax Board. In Container, the Supreme Court placed its imprimatur on the worldwide unitary method. The Court's decision, however, by no means resolved the matter. Indeed, in response to the outcry from the business community following this decision, President Reagan appointed a "Working Group" to study the issue and recommend solutions. The Working Group was chaired by the Secretary of the Treasury Donald T.Regan and included representatives of various states, the business community, and the federal government. After months of hearings and discussion, the Working Group "agreed" (subject to myriad qualifications from representatives of both business and the states) on three basic principles:

Principle One: "Water's-edge" unitary combination for both U.S. and foreign-based companies.

Principle Two: Increased federal administrative assistance to and cooperation with the states to promote full taxpayer disclosure and accountability.

Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

Those principles were set forth in the Chairman's Report on the activities of the Working Group. Since that report was released in 1984, much activity has occurred at the state level. Of the 12 states employing the worldwide unitary method at the end of 1983, nine have replaced the worldwide method with the "water's-edge" method. Most notably, the California legislature enacted replacement legislation in August 1986, which Governor Deukmejian signed into law on September 5.

Despite the "progress" that has been made in certain states to repeal the worldwide unitary method and in other states to reach a solution to the problem, TEI believes that federal legislation is necessary to resolve the disputes that have divided business and the states for decades. Federal legislation is needed for the following tax-policy related reasons:

First: Although the trend at the state level to repeal the worldwide unitary method is certainly welcomed by the business community, federal legislation is necessary to ensure that state administrators or legislators will not at some later date seek to impose the worldwide unitary method.

Second: Federal legislation is needed to ensure that no state, or subdivision thereof, is permitted to tax foreign-source dividends, since such taxation constitutes a mere extension of the worldwide unitary tax method. Currently, approximately 15 states, in addition to those currently employing the worldwide unitary method, include foreign-source dividends either wholly or partially in their tax bases.

Third: Federal legislation is needed to discourage states from taxing extraterritorial income (i.e., foreign-source dividends) by indirect methods. For example, in certain worldwide unitary states (including California), consideration has been given to imposing, as a condition of electing the "water's-edge" method, an assortment of onerous toll charges, filing fees, and other burdensome requirements. (The legislation recently enacted by the California legislature imposes such a toll charge on a corporation's electing not to use the worldwide unitary method.) Such conditions would clearly undermine the principles on which the Working Group agreed and dilute the overall efficacy of the corrective state legislation. Thus, federal legislation is necessary to establish clear, well-defined limits to the states' powers to tax multinational businesses.

IV. THE ESSENTIAL COMPONENTS OF FEDERAL LEGISLATION

Tax Executives Institute has filed reports and statements on the state taxation of multistate and multinational businesses with Congress and others. For example, in 1980 the Institute testified before the Senate Finance Committee on S. 1638 and before the House Ways and Means Committee on H.R. 5076, both of which would restrict the states' right to use the worldwide unitary method and to otherwise tax foreign-source income. In 1981, we testified before the Advisory Commission on Intergovernmental Relations in support of federal legislation defining and limiting the power of states to tax multijurisdictional businesses.

Most recently, TEI submitted comments on the proposed unitary tax legislation drafted by the Treasury Department and released for public comment on July 8, 1985. This draft legislation would have required certain corporations to file annual information returns with the Internal Revenue Service reflecting the computation of their state income tax liabilities in the various states. In noting that the Treasury Department had expressly deferred a decision on whether to press for federal legislation to remedy the worldwide unitary tax problem, TEI stated:

> Since the imposition of new information reporting requirements on multistate and multinational

> corporations, such as those proposed in the draft legislation, may constitute but one part of the perceived solution to the worldwide unitary taxation problem, TEI believes that the proposed domestic disclosure spreadsheet legislation is premature and that it should be held in abeyance pending the completion of the Secretary's review of this area.* * *
>
> * * * TEI believes that the domestic disclosure worksheet legislation is premature and that an improved proposal should be introduced only as part of a comprehensive solution to the conflicts that exist in this area.

TEI continues to believe that federal legislation is necessary to resolve the worldwide unitary issue. In our view, such legislation should contain the following elements:

1. Prohibit any state, or subdivision thereof, from imposing income tax on any taxpayer on a worldwide unitary basis. The federal legislation, however, should not operate to preclude states from affording taxpayers an election to use the worldwide unitary method.
2. Prohibit any state, or subdivision thereof, from including in its income base subject to taxation dividends received (or deemed received) from foreign subsidiaries of the taxpayer.
3. Provide a definition of "worldwide unitary basis" specifying which members of a controlled or affiliated group of corporations can be included in a combined return. In this respect, TEI believes that "section 936 companies" should generally not be includible in a "water's-edge" combined group. We take no position at this time on whether "80-20 companies" should be included or excluded from the group for combination purposes.

V. TEI'S POSITION ON PENDING FEDERAL LEGISLATION (S. 1974 AND H.R. 3980)

Tax Executives Institutes supports the enactment of federal legislation to resolve the worldwide unitary tax conflict and, consequently, supports the goals of S. 1974 and H.R. 3980, which are pending before the Senate and the House. In this regard, we commend the Senate Committee on Finance for scheduling a September 29, 1986, hearing on the proposed legislation, and we urge the House Committee on Ways and Means to follow suit.

We believe, however, that certain modifications to the proposed legislation are absolutely essential to achieve federal solution to the worldwide unitary problem. Our proposed changes are set forth below and are presented serially rather than in order of importance or prominence.

Proposed Section 7518(a)

This section would prohibit any state from imposing the worldwide unitary method on any taxpayer with two exceptions. A state could continue to use the unitary method --

(1) if the taxpayer materially fails to comply with the disclosure requirements set forth in section 6039A or the legal or procedural requirements associated with the income tax laws of the state; or

(2) if the taxpayer (or a relevant foreign country) fails to provide material information concerning the income transactions with certain related corporations.

TEI believes that the prohibition against the use of the worldwide unitary method must be unequivocal. Consequently, we object to the legislation's granting states the right in certain cases to use the worldwide unitary method. A taxpayer should not be threatened with the imposition of the worldwide unitary method (i) for failing to comply with the legal and procedural requirements imposed under the various state tax statutes and regulations, or (ii) for failing to provide information on transactions with related members of a controlled group. State law governing such disclosures and reporting requirements might not only be unacceptably vague or fluid but, for many if not most taxpayers, would be as administratively burdensome as the use of the worldwide unitary method itself.

Moreover, state tax codes already provide substantial civil and criminal penalties for such transgressions. Mandating the use of the worldwide unitary method in such situations would, in our view, be wholly unwarranted. Undoubtedly, this provision could lead to protracted litigation in which states and taxpayers would spar over the adequacy of the information disclosures.

In addition, the proposed legislation would apparently allow a state to apply the worldwide unitary method where the failure to disclose was not at all attributable to the taxpayer's actions -- for example, where a third party (*i.e.*, a foreign country) refused or failed to provide information regarding transactions between the taxpayer and a related corporation doing business in the foreign country. We submit that such a result would be inequitable.

Proposed Section 7518(b)

This proposed subsection would prohibit states from taxing more than an "equitable portion" of foreign-source dividends. By its terms, however, this restriction would not apply to the state of commercial or legal domicile of the taxpayer receiving such dividends. TEI submits that no state, including a taxpayer's state of commercial or legal domicile, should be permitted to tax foreign-source dividends. Conferring on any state the right to tax foreign-source dividends would contradict the underlying basis for prohibiting the state taxation of such income -- the prevention of the double taxation of extraterritorial income. Permitting any state to tax foreign-source dividends would perpetuate disputes concerning the appropriate scope of state taxation, not solve them.

Under the proposed legislation, a state would not be considered to include in its income base more than an "equitable portion" of a taxpayer's foreign-source dividends if it --

(1) excludes from its income base subject to taxation at least 85 percent of such dividends;

(2) excludes from its income base the portion of the dividends which effectively bears no federal income tax after application of the foreign tax credit; or

(3) considering all the facts and circumstances, effect an equitable apportionment of the dividends to the state substantially similar to (1) or (2), pursuant to regulations to be promulgated by the Secretary of the Treasury.

Although this proposed definition at first blush seems consistent with the intent of the legislation in restricting the taxation of foreign-source dividends, it leaves open many questions. Absent comprehensive regulations, it would be virtually impossible for taxpayers and the states to reach agreement on what portion of the taxpayer's foreign-source dividends "effectively bears no federal income tax after the application of the foreign tax credit." If history is any guide, regulations would not be promulgated for years, thus leaving the states and taxpayers without a clear understanding of how foreign-source dividends should be effectively taxed.

Moreover, it must be remembered that state allocation and apportionment schemes, as they relate to the transaction of multijurisdictional businesses, are intended to provide a mechanism for determining the "source" of the taxpayer's income, irrespective of the taxpayer's legal domicile or state of incorporation. Allowing states to tax foreign-source dividends would render this precept meaningless.

Proponents of the worldwide unitary method and the taxation of foreign-source dividends have frequently focused on the supposed ability of corporations to effectively shift income outside the United States. We suggest, however, that changes made by the Tax Reform Act of 1984 (specifically, amendments to section 367(d) of the Internal Revenue Code) have substantially reduced the force of such arguments. Indeed, the result of those changes, together with the Treasury Department's pledge to devote substantially more resources to the examination of international transactions, has been to significantly narrow any opportunity for unlawful income shifting that might have previously existed.

Therefore, TEI recommends that the proposed tests for determining what constitutes an "equitable portion" of a taxpayer's foreign-source dividends be cast as a single mathematical limitation. The 85-percent threshold found in proposed section 7518(b)(1) presumably is intended to result in the elimination from the state tax base of only the net foreign-source dividend received by a taxpayer, after reduction for appropriate related expenses. We propose that the second sentence of proposed section 7518(b) be redrafted, as follows:

> For purposes of this subsection (b), a state shall not be considered to include in its income base more than an equitable portion of dividends described in the preceding sentence if it excludes from the income base at least 85 percent of such actual dividends received or deemed received by the taxpayer.
>
> Notwithstanding the preceding sentence, no state shall include foreign dividend gross-up defined under section 78 [of the Internal Revenue Code] in its income base subject to taxation. Furthermore, no state shall disallow a taxpayer's deductions or credits as an offset against such dividends if such disallowance would have the effect of including in the states's income base more than 15 percent of such dividends.

In addition, proposed section 7518(b) should be modified to make it clear that the term "foreign-source dividends" includes subpart F income under sections 951-964 of the Internal Revenue Code and other foreign-source dividends received or deemed received by the taxpayer (including section 1248 gain and consent or deemed dividends).

Proposed Section 7518(c)(2)

The definition of the "worldwide unitary basis" set forth in the proposed legislation is clearly predicated on a "low-tide" mark. TEI submits it is unacceptable. Under the bill, states would be permitted to include in a "water's-edge" combination so-called possessions (section 936) corporations and 80-20 companies with payroll, sales, or purchases to or from unrelated parties or property exceeding a $10,000,000 threshold. As already noted, TEI takes no position on whether 80-20 companies should be included in a permissible "water's-edge" group. As to possessions corporations, we submit there are several reasons for excluding them from a "water's-edge" combination.

First, transactions with such companies are already subject to Internal Revenue Service review to determine whether income has been unlawfully transferred outside the U.S. taxing jurisdiction. Secondly, the basic complaints associated generally with the worldwide unitary method (i.e., that income earned outside the United States is disproportionate in relation to the factors used to allocate such income under the various state formulary methods) are equally applicable to these companies. Lastly, as part of the federal solution to the worldwide unitary problem, the Treasury Department has already agreed to strengthen its audit and review of transnational intercorporate transactions. This pledge should provide sufficient comfort to those states otherwise concerned about the ability of taxpayers to shift income outside jurisdictions.

Proposed Section 6039A -- Information With Respect to Certain Multistate and Multinational Corporations

As an organization whose members are responsible for ensuring that their companies comply with the tax laws, TEI is very much concerned about the administrative burden posed by the proposed information reporting requirements set forth in section 6039A of the proposed legislation. In this regard, we seriously question whether the time and costs required to fulfill these requirements have been adequately justified by its proponents. In its present form, the legislation would impose significant burdens on many corporations not conducting any or more than a nominal amount of business outside the United States.

In addition, the compliance requirements for those companies subject to the proposed legislation could, in our opinion, be as onerous as the worldwide combined reporting burden that now exists for many taxpayers, even though the amount of useful information provided to the states would be generally minimal. Clearly, where the information obtained is of marginal value, this type of burden is wasteful in terms of both personnel and financial resources.

Notwithstanding the foregoing comments, should Congress still feel compelled to include the information reporting requirements in the proposed legislation, TEI believes that certain changes are necessary to ensure that the legislation is administrable, equitable, and consistent with longstanding tax policy goals. Not the least of the required changes relates to the discretionary authority that would be granted the Secretary of the Treasury under proposed section 6039A(a) to expand the nature and volume of information required to be submitted by a reporting corporation. In our view, that discretionary authority should be eliminated. Thus, only those items specifically identified in proposed section 6039A(a) -- essentially, income tax liability, method of calculation, and affiliated company transactions -- should be required to be included on the domestic disclosure spreadsheet (DDS).

Other changes recommended by TEI to the domestic disclosure spreadsheet requirements are set forth below.

Proposed Section 6039A(c)

Under the proposed legislation, a "reporting corporation" required to file the DDS return includes a corporation that "is subject to tax in at least two states, and owns total assets with an aggregate original cost of at least $250,000,000, at least $10,000,000 of which are located in the United States." We submit the proposed definition is excessively broad. The overall purpose of the legislation is to resolve the conflict between the states and business over worldwide unitary taxation. Under the bill, however, many large corporations (i.e., those with total assets of $250 million or more) that conduct no or only de minimis foreign activities would be required to comply with the DDS requirements. In addition, small and medium-sized businesses that merely export $10 million or more of products outside the United States would be subject to the DDS requirements.

TEI submits that corporations that conduct no or only de minimis business outside the United States and those corporations that engage in foreign commerce only through direct export sales should not be subject to the DDS reporting requirements. In this regard, the Department of Commerce has taken issue with the proposed legislation and expressed the federal government's need to balance the interests of the states in obtaining information regarding the activities of multinational corporations against the need not to overburden businesses with substantial reporting requirements of little or no value. Specifically, in a letter dated August 22, 1985, Douglas A. Riggs, the Commerce Department's General Counsel, argued persuasively that the proposed DDS guidelines issued by the Treasury Department on July 8, 1985 (after which the DDS requirements found in S. 1974 and H.R. 3980 are patterned) should be moderated. Mr. Riggs stated that DDS requirements --

> will place a difficult burden on small and middle sized U.S. companies, which have no direct investment abroad and should not be subject to the unitary remedies at all. Furthermore, such companies, unlike true multinationals with active subsidiaries and branch operations abroad, have virtually no potential for immunizing their profits from local state taxation.

TEI agrees with the Commerce Department that only those corporations that are directly involved in the worldwide unitary tax dispute should be drawn into the legislative net. Consequently, we recommend that the definition of "reporting corporation" be modified to exclude purely domestic companies. Specifically, we urge the exclusion from the combined group of those companies conducting only de minimis foreign business (i.e., those companies deriving five percent or less of their revenues from the sale of products or services through the active conduct of business outside the United States), and those companies engaged in foreign commerce merely through the direct export or import of personal property to or from unrelated parties (i.e., not conducting business through a foreign branch, office, fixed place of business, permanent establishment, or subsidiary -- other than a FSC or DISC).

Proposed Section 6039A(d)

In addition to the federal penalty provisions set forth in proposed section 6039A(e), proposed subsection (d) would provide that the states may treat the filing of the DDS return with the Internal Revenue Service as if it were also originally filed with the states for purposes of imposing state penalties for negligence, fraud, or a material understatement of income or tax liability. Such a provision is both unnecessary and ill-advised. Indeed, because it could lead to the inconsistent application of various state laws to federally required disclosures and, in fact, sanction the unequal treatment of similarly situated taxpayers, it represents bad tax administration and even worse tax policy.

The penalties imposed by the Internal Revenue Code are substantial and, we believe, wholly sufficient to discourage noncompliance with the reporting requirements. If states were permitted to levy additional civil or criminal penalties with respect to DDS returns, a taxpayer could face multiple assertion of such penalties -- the particulars of which might depend on the vagaries of each asserting state's tax laws, administrative regulations, and enforcement practices. As a result, the taxpayer could be placed in the position of defending itself against scores of separate, perhaps even inconsistent, state determinations with respect to the same DDS return.

Enforcement of proposed section 6039A should be left to a single general agency -- the Internal Revenue Service -- that can assure that the provisions are interpreted and applied in a consistent, even-handed manner. Accordingly, TEI recommends that proposed section 6039A(d) be deleted in its entirety.

VI. CONCLUSION

Tax Executives Institute applauds Congress's and the Administration's efforts to seek a federal solution to the worldwide unitary problem. S. 1974 and H.R. 3980, although requiring significant amendments, provide a sound foundation for achieving this objective. Consequently, TEI urges Congress to take immediate action on this legislation. TEI requests that the specific recommendations discussed above be taken into consideration since they are believed to be necessary to assure that the solution is both fair and enduring.

TEI appreciates this opportunity to present our views on proposed federal legislation relating to the states' use of the worldwide unitary method. If you should need additional information or wish to discuss these comments, please do not hesitate to call James F. Buresh, chairman of TEI's State and Local Tax Committee, at (312) 875-9010 or Timothy J. McCormally, TEI's Tax Counsel, at (703) 522-3535.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

By: David L. Burn
President

VII. APPENDIX:
HISTORY OF THE PROBLEM

On June 27, 1983, the Supreme Court of the United States held that California's application of the worldwide unitary method of taxation to Container Corporation of America and its foreign subsidiaries was proper. Container Corporation of America v. Franchise Tax Board, 103 S. Ct. 2933 (1983). In so holding, the Court found that California is not required "to employ the arm's-length approach used by the Federal Government and most foreign nations in evaluating the tax consequences of intercorporate transactions," that "the double taxation occasioned by the California scheme is not impermissible," and further that the "California tax does not violate the 'one voice' standard * * * under which a state tax at variance with federal policy will be struck down if it either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive."

As a result of the Court's decision and the concern that additional states might incorporate the worldwide unitary method into their own taxing systems, affected members of the business sector (joined by major foreign trading partners of the United States) stepped up their efforts to have the federal government ban the worldwide unitary tax method by urging the President to intercede in the dispute. At the same time, supporters of the worldwide unitary method implored the Administration not to interfere in what they perceived to be primarily a "states' rights" issue. In response to the concerns expressed by both the proponents and opponents of the worldwide unitary method, President Reagan established a "Working Group," whose members represented the affected parties in the dispute: multinational corporations, state governments utilizing the worldwide unitary method, and the federal government. The Working Group was charged with examining the issues and formulating recommendations that would "be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states."

The Working Group, chaired by Secretary of the Treasury Donald T. Regan, heard testimony and debated the issues for a period of five months. The results of these hearings were transmitted to the President in the Chairman's Report On The Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations (July 31, 1984). The Report set forth the following three principles:

> Principle One: "Water's-edge" unitary combination for both U.S. and foreign-based companies.
>
> Principle Two: Increased federal administration assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

The Report noted that the state representatives and the representatives from the business community were not able to reach a consensus on two key areas:

(1) whether states should have the right to tax foreign-source dividends; and

(2) whether so-called 80-20 corporations should be includible in a "water's-edge" unitary combination.

The states argued that foreign-source dividends should not be exempted from their tax bases; business representatives countered that allowing states to tax foreign dividends would effectively expand, rather than constrict, the use of the worldwide unitary method. The difference of opinion over the proper treatment of 80-20 companies was equally diverse, with the states arguing for inclusion of such companies in the "water's-edge" definition and business proposing a "high-tide" definition favoring exclusion of such companies. (As noted above, TEI has to date taken no position on whether 80-20 companies should be included in the definition of the "water's-edge" unitary group.)

Thus, in the final analysis, the Working Group failed to agree on a comprehensive solution to the worldwide unitary question. Instead, Chairman Regan exhorted the states still using the worldwide unitary method to resolve the dispute with new state legislation. In his report, he stated that if the states had not made "appreciable progress" to eliminate the use of the worldwide unitary method by July 31, 1985, he would recommend that the Administration support federal legislation to correct the problem.

On July 8, 1985, the Treasury Department issued for public comment draft legislation requiring certain corporations to file information returns with the Internal Revenue Service reflecting their computations of state income taxes in the various states. This legislation was intended to promote Principle Two of the Working Group Report--federal assistance in promoting full taxpayer disclosure and accountability. Two days after the Treasury Department released the draft domestic disclosure spreadsheet legislation, the British House of Commons approved a measure that would permit the United Kingdom to retaliate against those states employing the worldwide unitary method by withholding tax refunds on dividends paid by U.K. subsidiaries of U.S. parent companies doing business in worldwide unitary states.

On August 16, 1985, the Treasury Department issued a News Release stating that "positive developments" had occurred at the state level over the course of the previous year. The News Release specifically commented on the efforts then underway in California to enact "water's-edge" legislation. In light of the developments, the Treasury Department announced it had deferred consideration of whether to recommend federal legislation to solve the worldwide unitary taxation dilemma. The Treasury acknowledged, however, "that important steps remained to be taken by the states before the unitary taxation problem [could] be considered to be satisfactorily resolved." Most observers linked the Treasury Department's decision to defer consideration of federal legislation to the intense efforts underway by the California legislature to reform the worldwide unitary method system. Unfortunately, the California legislature adjourned in September of 1985 without enacting a "water's-edge" bill.

In light of the failure of the California lawmakers to enact "water's-edge" legislation during 1985, combined with the stepped-up pressure by foreign governments (most notably, the United Kingdom) on the Administration to intercede, the President announced on November 8, 1985, that the Administration would support federal legislation compelling the remaining states to abandon the worldwide unitary method of taxation and provide restrictions on the states' rights to tax foreign-source dividends. On December 18, 1985, S. 1974 was introduced in the Senate by Senator Wilson of California and, on the same day, Representative Duncan of Tennessee introduced a companion bill, H.R. 3980, in the House of Representatives. This legislation generally would prohibit the use of the worldwide unitary method, would restrict the state taxation of foreign-source dividends, and would impose new disclosure requirements on multistate and multinational corporations.

Notwithstanding the introduction of S. 1974 and H.R. 3980, the Administration made it clear that it would prefer for the states to resolve the worldwide unitary dispute without the need for federal intervention. In a letter dated January 30, 1986, to the governors of the six states still using the worldwide unitary method, Secretary of State George Schultz urged the states to abandon the use of the method. He stated that the Administration "would welcome swift legislative or administrative action by your state to terminate your state's use of the worldwide unitary method of taxation and to limit your state's taxation of foreign-source dividends." Furthermore, in a letter dated March 14, 1986, to California Assembly Republican Leader Pat Nolan, J. Roger Mentz, Acting Assistant Secretary of the Treasury for Tax Policy, stated:

> [T]he fact that California continues to tax on a worldwide unitary basis presents serious problems to the Administration. We hope that California, like other states, will be able to resolve this difficult problem by enacting legislation that is consistent with the federal legislation. This action would stand as a tangible expression of the workability of federalism. It also would prompt us to reassess the need for the federal legislation.

On August 26, 1986, the California legislature approved a compromise unitary tax reform bill (SB-85). Governor Deukmejian signed the measure into law on September 5. The bill offers multinational corporations currently taxed under California's worldwide combined reporting method an option to be taxed on a "water's-edge" basis, as of January 1, 1988. Generally, corporations can continue to be taxed based on the California portion of their worldwide unitary income or they can elect to use a rolling 10-year period to compute their tax based on the California portion of their U.S. income. It should be noted that, under the California legislation, domestic international sales corporations (DISCs), foreign sales corporations (FSCs), and "80-20 corporations," and other companies -- regardless of where incorporated -- with 20 percent or more of their average property, payroll, and sales within the United States would be included in the "water's-edge" group.

Under SB-85, the election will not come without cost to the corporation. Specifically, companies reporting under the election provision will be required to pay an annual fee of .03 percent of their property, payroll, and sales in California. This fee can be reduced to a minimum of .01 percent by making new investment in the state. Under the legislation, 75 percent of dividends received from foreign subsidiaries owned more than 50 percent by the parent will be exempt from taxation, with adjustments possible based on the relationship of domestic payroll to total payroll. Finally, taxpayers making the election will not be able to revoke it for 10 years.

The bill also contains several provisions unrelated to combined reporting reform, including a requirement that many corporations file a domestic disclosure spreadsheet similar to that which would be required by H.R. 3980 and S. 1974. The spreadsheet would have to be filed without regard to whether the corporations have foreign operations or elect the new reporting method.

Since the California legislation will not become effective until 1988 and since the measure will require that certain studies and reports be made to the legislature during its 1987 session, it remains unclear whether uniform reform in California is at an end.

Meanwhile, judicial developments concerning the unitary issue have continued. Specifically, on March 6, 1986, the Justice Department filed an *amicus curiae* brief in the case of *Alcan Aluminum Limited v. Franchise Tax Board*, No. 84 C 6932 (N.D. Ill. Jan. 10, 1985), which is pending before the U.S. District Court for the Northern District of Illinois. In its brief, the Justice Department argued that the worldwide unitary method, as it applies to foreign-based multinationals, is offensive to the Foreign Commerce and Supremacy Clauses of the Constitution, because it resulted in impermissible interference with the federal government's implementation of national policies and the conduct of foreign affairs. On March 22, 1986, *amici curiae* briefs were filed on behalf of 17 foreign governments asking the court to strike down California's worldwide unitary tax.

It is expected that the *Alcan* case may ultimately reach the Supreme Court of the United States. A final decision by the Court, however, may not be forthcoming for several years. Should the worldwide unitary tax method be found unconstitutional as it applies to foreign-based multinationals, the focus may again shift to Congress to consider the extent to which such a decision would have on the Working Group's third principle -- to strike a competitive balance between U.S.-based multinationals, foreign-based multinationals, and purely domestic companies.

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STATEMENT OF TEXACO INC.
TO THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
UNITED STATES SENATE

Texaco Inc. (Texaco) appreciates the opportunity to submit written comments on the proposed Unitary Tax Repealer Act (S. 1974). Texaco is a wholly integrated oil company that either directly or through subsidiaries and affiliated companies conducts oil and gas exploration, production, transportation, refining and sales activities in the United States and in over 160 countries throughout the world. Texaco, a Delaware Corporation, has filed a consolidated federal tax return since 1954.

The Administration and this Committee are to be commended for their efforts to resolve the international controversy surrounding the individual states imposition of the worldwide unitary method of taxation. Important in this endeavor is the attempt to provide for the "equitable" taxation of foreign source dividends. Texaco wishes to emphasize that any limited resolution of the worldwide unitary issue without restriction on the state taxation of foreign source intercorporate dividends and other foreign income would disadvantage domestic corporations in their foreign operations.

Texaco strongly supports the enactment, with modifications, of S. 1974, which is before the Senate Finance Committee for consideration, and its identical companion bill HR. 3980, which is before the House Committee on Ways and Means.

I. Background

This legislation was drafted by the Administration and was introduced into both chambers at the request of the President. S. 1974 was introduced on December 10, 1985, by Senator Pete Wilson for himself, and Senators Mathias and Hawkins. HR. 3980 was introduced on the same day by Congressman Duncan. Since introduction, Congressmen Gibbons, Jenkins, Archer, Frenzel, and Daub have agreed to co-sponsor HR. 3980.

In brief, this legislation would apply a water's-edge approach to state taxation of corporate income by (1) prohibiting states from imposing corporate income tax on a worldwide unitary basis; and (2) providing for "equitable" tax treatment of dividends received by U.S. corporations from their foreign subsidiaries. In exchange, all states would benefit under this legislation from the establishment of new federal information reporting requirements for multinational corporation groups and certain other corporations. Such information is intended to assist the states in the administration of their tax laws.

II. The Need For Federal Tax Legislation

There is a strong need for federal legislation notwithstanding the recently enacted California legislation. The dispute over the constitutional propriety of the worldwide unitary tax method to compute the state tax liabilities of multinational businesses has plagued national governments, the business community, and the states for many years.

The resolution is important now for the following reasons:

(1) Only federal legislation can give the uniformity, equality and the consistency necessary to prevent the disruption of international relations by individual arbitrary state tax action which taxes income earned outside of the United States and is not related in any way to the taxed company's operations in the state.

(2) To permit action by one state (California) to deter federal legislation gives the impression to foreign governments that it is California and not Congress which determines the tax rules in foreign commerce.

(3) The enacted California legislation does not repeal worldwide unitary because the California Franchise Tax Board at its own discretion may ignore the taxpayer's water's-edge election.

(4) California legislation can be easily repealed and other states could still impose unitary taxation. Thus, foreign governments will be required to maintain the threat of tax retaliation as the United Kingdom has done.

(5) "California" type solutions favor mainly foreign-owned multinationals and, as a result, place domestic multinational companies at a disadvantage. The foreign source dividends of foreign-owned companies are fully exempt from California taxation, but U.S. multinational companies are subject to tax on all or part of their foreign source dividends.

(6) California extracts a heavy toll charge (.03% of business activities in California) for the option to elect water's-edge unitary tax relief from worldwide unitary taxation -- an unfair cost to multinational companies. Moreover, the election fee can be increased by California in the future.

(7) The California legislation discriminates against U.S.-based multinationals in favor of the foreign-based multinationals by including 80/20 corporations in the water's-edge unitary combination.

(8) To permit states to tax foreign source income and require companies to report on such foreign operations results in oppressive administrative and compliance costs for companies which are required to report on their complete worldwide operations even though such information is often not readily available to those companies.

(9) Requires a determination of income which is based on apportionment factors that can significantly understate income earned by foreign operations, and overstate income earned in the state and therefore result in double taxation.

For the above reasons, individual state taxation on a worldwide unitary basis of internationally generated income and taxation by states of foreign source dividends is simply not good international tax policy and it is not good foreign policy when states are permitted to act individually and independently in areas of foreign income taxation.

III. Basic Principle of Taxation Which Texaco Supports

The basic principle to which Texaco adheres is that states, like the United States, should recognize the established principles of international taxation so that the foreign source income determination be made on the established "arms length" principle (also referred to as the "separate accounting" principle) uniformly and historically followed by the international community. The "arms length" method of determining the source of taxable income would preclude formulary apportionment which is the basis of the unitary method of taxation as followed by California and other unitary states.

Under the "arms length" principle, foreign source income should be defined for state taxation purposes by federal law (consistent with international tax principles) and formulary apportionment of foreign source income should be prohibited as a permissible method of determining income arising from activities within their states and income reasonably related thereto. In addition, foreign source income (dividends or operating income) should be excluded from state taxation so that U.S. corporations competing overseas would not have a competitive disadvantage.

IV. Federal Restrictions on State Taxation of Foreign Source Dividends is Essential

Texaco's major concern with respect to the specific legislation currently before the Congress is the "equitable" taxation of foreign source dividends. We note that the concept of "equitable" taxation of foreign source dividends has been adopted by the Administration and is part of this legislation. However, our concern is that because of the wide disparity in views as to what will constitute "equitable" taxation, the "equitable" concept may not be practicable or workable. We believe that the foreign source dividends, like any other foreign source income, should not be subject to any state taxes. It is clear that the foreign parent corporation will be able to have 100% of their foreign source income (dividends) protected from U.S. federal and state taxation. Accordingly, we believe that U.S. multinationals should not be placed in a less competitive position.

Although Texaco does not favor the "equitable" taxation of foreign source dividends as proposed in S. 1974, in order to have "equitable" taxation of dividends, the following principles should apply:

(1) Foreign source dividends received by foreign-based multinationals will be excluded from state taxation by state law or by lack of "nexus"; therefore, "equitable" treatment requires the same exclusion for foreign source dividends received by U.S. corporations either from foreign or domestic corporations.

(2) Exclusion of foreign source dividends from state taxation should not be thwarted by interest expense or any other expense disallowance. Allocation of interest expense between domestic and foreign operations for state tax purposes should follow federal rules.

(3) Alternatively, interest and other expense allocation by the states should be prohibited if there is not a full exclusion of foreign source dividends (such as an 85% exclusion). The 15% inclusion should replace all expense allocations.

(4) Dividends should not include Section 78 gross-up; income which is deemed a dividend for purposes of Subpart F as well as Section 1248, and those derived from 80/20 companies.

S. 1974 provides that 85% dividend exclusion represents "equitable" taxation of foreign source dividends. We respectfully suggest that the only manner in which taxation of 15% foreign source dividends could be "equitable" would be that the 15% represents a fair allocation of associated expenses attributable to foreign source income including interest offsets. Accordingly, we would urge that as a necessary element of "equitable" taxation, further disallowances of expenses of the parent corporation, such as the interest expense offset, or any other expense disallowance, should be prohibited if 15% of the dividend income is to be subject to state taxation. Alternatively, we would urge that if the states are permitted to disallow or allocate expenses attributable to foreign source income, then taxation of foreign source dividends should be entirely prohibited. We suggest that if the 85% safe harbor treatment of foreign source dividend taxation is included, then such approach should be in lieu of allocation of expenses related to foreign source income.

V. Taxation On a Worldwide Unitary Basis Is Inconsistent With the Tax Policies of the United States

State taxation on a worldwide unitary basis has produced a significant deterioration in the relationship of the United States and its principal trading partners. The worldwide unitary method of state taxation has undermined the ability of the federal government to speak with one voice in foreign tax policy matters. In fact, the continued use of this method of taxation by the states impairs the ability of the United States to carry out its tax and investment policy in the international arena and alienates our economic allies and exposes the United States business community to increased taxation, administrative costs in foreign jurisdictions, and to severe trading disadvantages in competing in the international community. The water's-edge approach of S. 1974 will permit the federal government to once again regain control of the United States international tax policy. This bill will provide for a simple and fair guideline for states to enact a consistent network of water's-edge legislation.

VI. Federal Legislation Is Necessary to Assure Equitable Treatment of American 80/20 Companies

The new California legislation illustrates the need for federal legislation to restrict states from not only discriminating against American companies in favor of foreign competitors, but also from discriminating against some American companies in favor of other American companies. This situation results from California's exclusion of American incorporated companies from the benefits of a water's-edge combination, even though they have more than 80% of their operations overseas the so-called "80/20 company" under the Internal Revenue Code.

This legislation should adhere to the principles that the United States espouses in the double taxation treaty agreements to which it has entered. Thus, the water's-edge definition should be based upon the concept of limiting state taxation of income to those individual companies (of an affiliated group) that have a permanent establishment in the U.S. If the permanent establishment concept cannot be easily adopted, then the test to determine whether foreign corporations are within the water's-edge should be a simple calculation based on an analysis of the sources of the corporations gross income. For example, if at least 20% of a corporation's worldwide gross income consists of U.S. source income which is not effectively connected with a U.S. trade or business, or income from U.S. or foreign sources which is effectively connected with a U.S. trade or business, then the corporation would be within the water's-edge and subject to taxation on a worldwide unitary basis.

Including an 80/20 corporation in the water's-edge unitary combination merely because it is incorporated in the U.S. discriminates against the U.S.-based multinationals in favor of the foreign-based multinationals because a similarly situated foreign subsidiary of a foreign corporation would not be included in the water's-edge combination and the income therefore not subjected to formulary apportionment.

VII. The Worldwide Unitary Method Should Not Be Used As a Penalty

The basic purpose of Section 7518 of S. 1974, is to restrict the use of the worldwide unitary method of taxation. This is a sound approach and one supported by Texaco. However, Section 7518(a)(1) and (2) would allow the states to require the use of the worldwide method of taxation as a penalty or sanction. Using the worldwide method as a sanction in regulating a tax system is inappropriate.

With respect to Section 7518(a)(1), most state statutes provide for civil and criminal penalties for taxpayers who materially fail to comply with the income tax laws of the state. With respect to 7518(a)(2), to prevent the disruption of international relations by individual arbitrary state actions and to maintain uniformity, all information from foreign governments concerning income transactions with certain related corporations should be obtainable only through the IRS or the State Department and disbursed to the states.

Therefore, we recommend that Section 7518(a)(1) and (2) be deleted.

VIII. The "Spreadsheet" Informational Requirements Should Not Be Enacted Without Unitary Tax Relief

In noting that the Treasury Department has expressly deferred a decision on whether to press for federal legislation at this time to remedy the worldwide unitary problem, including the state taxation of foreign source dividends, Texaco strongly urges that it would be equally wrong to go forward with imposing new information reporting requirements on multistate and multinational corporations, such as those proposed in the draft legislation. Such legislation would constitute but one part of the perceived solution to the worldwide unitary taxation problem. In arriving at the three basic principles which the working group agreed upon, it cannot be over-emphasized enough that the increased federal administrative assistance and cooperation with the states in order to promote full taxpayer disclosure and accountability was a principle which was provided primarily for the states benefit and that the other two principles which were agreed upon which would provide for a water's-edge unitary combination for both U.S. and foreign based companies and which would provide that there be a competitive balance for U.S. multinational, foreign multinational, and purely domestic businesses, was the quid pro quo with respect to these principles which the business community supported. To enact at this time only that portion of the legislation will only benefit the states; without consideration of legislation to benefit business would be most inappropriate and would undermine the concept of the working group agreement. The proposed domestic disclosure spreadsheet legislation is premature and it should be held in abeyance pending the completion of an improved proposal that will be introduced as part of a more comprehensive solution to the conflicts that exist in this area.

IX. The Spreadsheet Provisions Are Generally Acceptable as an Inseparable Part of Unitary Taxation Relief

As long as this legislation provides for the basic principles which the business community required including a water's-edge unitary combination for both U.S.- and foreign-based companies and a competitive balance for U.S. multinationals, foreign multinationals and purely domestic businesses, the Federal disclosure spreadsheet provisions are generally acceptable.

The Federal disclosure spreadsheet provisions of Section 6039(a) of S. 1974 are designed to provide the states with federal assistance in gathering information that is necessary for them to administer their tax laws relating to multinational businesses. Subject to the non-disclosure provisions of the bill, there is no objection to providing the reporting corporations income tax liability paid to each state, the income subject to tax in each state, and the method of calculation in which the reporting corporation computed and allocated its income subject to tax by each state. However, such information should only be provided to the Internal Revenue Service and to the appropriate state Departments of Revenue for their restricted use. Consequently, we recommend deletion of all reference to common agency. Furthermore, the requirements as set forth in Section 6039(a) and (b) to report on companies owned by affiliates should be applied only where they own more than 50% of the outstanding stock of the company.

Texaco continues to believe that federal legislation is necessary to resolve the entire worldwide unitary taxation dispute. In our view, such legislation should contain the following elements:

1) Prohibit any state or subdivision thereof from imposing an income tax on any taxpayer on a worldwide unitary basis. The federal legislation, however, should not operate to preclude states from affording taxpayers an election to use the worldwide unitary method.

2) Prohibit any state or subdivision thereof from including in its income base, subject to taxation, any intercorporate dividends received (or deemed received) from foreign subsidiaries, affiliates, or domestic companies operating wholly in a foreign area.

3) Provide a definition of worldwide unitary basis specifying no members of a controlled or affiliated group of corporations shall be included in a combined return unless the members are carrying on more than a substantial amount of business in the U.S. In this respect, Texaco believes that 80/20 companies should not be included in a water's-edge combined group.

Texaco applauds Congress' and the Administration's effort to seek a federal solution to the worldwide unitary tax problem. S. 1974 and HR. 3980, although requiring modification, provide a sound foundation for achieving legislation which will embody the three basic principles agreed upon by the working group business and state representatives. Consequently, Texaco urges Congress to take immediate action to enact this legislation. We request that the specific recommendations discussed above be taken into consideration, since we believe them to be necessary in order to insure that the solution to this problem is both fair and enduring. We appreciate this opportunity to present our views on the proposed Unitary Tax Repealer Act federal legislation. If you should need any additional information, or wish to discuss any of these comments, please do not hesitate to contact the undersigned at 2000 Westchester Avenue, White Plains, NY 10650. I may be reached by telephone at (914)253-6210 or (202)331-1427.

Respectfully submitted,

TEXACO INC.

Robert S. Bevan
General Tax Counsel

UNICE UNION DES INDUSTRIES DE LA COMMUNAUTÉ EUROPÉENNE

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PROPOSED UNITARY TAX LEGISLATION - S. 1974

US Senate Finance Committee

Hearing before the Subcommittee on Taxation on Monday 29 September 1986

With reference to the United States Senate press release issued on 11 August 1986, UNICE respectfully submits to the Taxation Subcommittee the following written statement:

1. UNICE is a confederation of the industrial associations of the Member States of the European Economic Community (EEC *) and of the European Free Trade Association (EFTA **). Most major industrial corporations in these eighteen countries are affiliated to UNICE's members.

   Most direct foreign investment in the United States comes from European sources, the overwhelming majority of which are multinational corporations affiliated to one of UNICE's member Federations.

2. UNICE is also authorised to make this submission on behalf of the European Banking Federation, which represents the twelve banking associations of the Member States of the EEC. These associations comprise the one thousand seven hundred full range service commercial banks established in the EEC, several of which either have branches in the United States or are considering establishing one there.

3. UNICE and the European Banking Federation urge the Committee to give urgent and favourable consideration to S.1974.

4. In the opinion of both organisations, it is only through federal legislation that a satisfactory universal and lasting solution will be found to the prohibition on the use of the worldwide unitary method of taxation by the States.

   As to the reasons for this view, UNICE and the European Banking Federation would refer to the testimony which Mr Harry Corless gave at the Subcommittee's oral hearing on behalf of the Organization for the

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*) The Member States of the EEC are Belgium, Denmark, France, Federal Republic of Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

**) The Member States of EFTA are Austria, Cyprus, Finland, Norway, Sweden and Switzerland.

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Fair Taxation of International Investments "OFTII" (a summary of the OFTII statement is attached). UNICE and the European Banking Federation strongly support the arguments in the OFTII statement in favour of federal legislation, as well as its more detailed comments on the substance of S.1974.

5. In conclusion, UNICE and the European Banking Federation look forward to the satisfactory solution of this long-standing problem with the early passage of the Bill, suitably amended.

Zygmunt Tyszkiewicz
Secretary General

Enclosure: summary of OFFTI statement

Annex to the UNICE submission

SUMMARY OF OFTII TESTIMONY ON S.1974.

OFTII is composed of twenty-four domestic companies owned by foreign shareholders. OFTII members have invested billions of dollars in the U.S. and created thousands of jobs for American workers. OFTII members have been penalized unfairly by worldwide unitary taxation in certain States because they are taxed under this method on a portion of the income earned by their foreign shareholders or related companies in foreign countries. This substantially disadvantages worldwide enterprises that have investments in unitary tax States and discourages investments in the U.S. Recent unitary tax legislation in California has not dealt adequately with the problem. Several States still retain fully worldwide unitary taxation; the California measure only provides partial relief in the form of an "election" upon payment of a substantial fee to which the taxpayer is committed annually for ten years without regard to the amount of taxable income; the California tax. authorities have the power under vague criteria to terminate the "election" and the law does not take effect until 1988. OFTII members do not see this as a statisfactory solution to their concerns and are continuing to litigate in State and federal courts to have worldwide unitary taxation finally declared unconstitutional. OFTII members urge that the appropriate solution is federal legislation, much in the form of S.1974 with relatively few technical changes. These changes, the details of which are specified in the full statement, are proposed to ensure that State unitary taxation is limited to the "water's edge" and cannot be expanded to include foreign enterprises not doing business in the United States; that definitional matters are clarified; that compliance for State tax purposes is made uniform and administered federally; and that stringent monetary penalties are applied to ensure compliance under federal law with reasonable and appropriate State revenue requirements.

Statement
# of the
Chamber of Commerce
# of the
United States

ON: FEDERAL LEGISLATION PROHIBITING STATE TAXATION ON THE WORLDWIDE UNITARY BASIS

TO: SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE COMMITTEE ON FINANCE

BY: DAVID R. BURTON

DATE: SEPTEMBER 29, 1986

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents approximately 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 58 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 11,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
ON
FEDERAL LEGISLATION PROHIBITING STATE TAXATION
ON THE WORLDWIDE UNITARY BASIS
for submission to the
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
of the
SENATE COMMITTEE ON FINANCE
for the
U.S. CHAMBER OF COMMERCE
By
David R. Burton*
September 29, 1986

I. SUMMARY OF PENDING FEDERAL LEGISLATION

On December 18, 1985, S. 1974 was introduced by Senator Wilson of California, and a companion bill, H.R. 3980, was introduced by Representative Duncan of Tennessee. These bills attempt to resolve the ongoing dispute over states' use of the worldwide unitary tax method by: (1) prohibiting the states from using the worldwide unitary tax method to compute a corporation's state income tax liability; (2) restricting the state taxation of foreign-source dividends; and (3) imposing comprehensive new disclosure and information reporting requirements on certain multistate and multinational corporations.

II. CALIFORNIA UNITARY LEGISLATION

In 1983, the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board* held that *California's use of the worldwide unitary method of taxation* was constitutional. Shortly after the court's decision, at the request of the business community, a Working Group was appointed to recommend solutions to the unitary issue. After a series of prolonged hearings, the Working Group, comprised of representatives of both business and the state and federal government, agreed on three basic principles:

Principle One: Water's-edge unitary combination for both U.S. and foreign *based companies*.

Principle Two: Increased federal administrative assistance to and cooperation *with the states* to promote full taxpayer disclosure and accountability.

Principle Three: Competitive balance for U.S. multinationals, foreign *multinationals* and purely domestic businesses.

In the three years since the Working Group began its work on the unitary issue, nine of the 12 states still utilizing the worldwide unitary method at the end of 1983 have replaced the worldwide method with the water's-edge method. Most recently, the California legislature approved a compromise unitary tax reform bill which Governor Deukmejian signed into law on September 5, 1986.

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Under the compromise bill, all corporations may elect to report income for California bank and corporation tax purposes using a water's-edge apportionment method as of January 1, 1988. Companies electing to be taxed under the water's-edge method will be required to pay an annual fee of 0.03 percent of the sum of their property, payroll and sales in California. In addition, electing companies will not be able to revoke such water's-edge election for a period of 10 years except with permission of the state tax authorities.

The definition of the water's-edge group under the California legislation includes foreign sales corporations (FSC's), domestic international sales corporations (DISC's), U.S. corporations with primarily foreign operations (80/20 companies) and Subpart F income. The bill also provides that 75 percent of dividends received from controlled foreign corporations (CFC's) owned more than 50 percent by the parent will be exempt from taxation. This 75 percent exemption of foreign-source dividends, however, could be reduced significantly over time for companies that increase their foreign payroll relative to their domestic payroll. Finally, all corporations subject to California jurisdiction would be required to file a domestic disclosure spreadsheet similar to that proposed by S. 1974 and H.R. 3980.

While the U.S. Chamber commends California for taking steps to alleviate the unitary problem, the California legislation does adequately not do so. Some of the problems with the California bill are:

(1) The water's-edge group should not include FSC's, DISC's, 80/20 companies and Subpart F income. The objective of water's-edge legislation is to tax only such income that can be described fairly as earned within that state. Income from these types of companies is earned outside of California and as such should not be taxed by the state under a true water's-edge approach.

(2) One hundred percent rather than 75 percent (or less depending on a corporation's percentage increase in foreign payroll) of foreign-source dividends should be exempt from state taxation. State taxation of any portion of foreign source dividends is an extension of the worldwide unitary tax method. Since 15 states in addition to those three states currently using the worldwide unitary method include at least part of foreign source dividends in their tax bases, federal legislation is necessary to ensure that foreign dividends are not taxed.

(3) The 0.03 percent fee imposed on companies electing to be taxed under the water's-edge method undermines the benefit of California's water's-edge legislation. This election fee percentage could be increased easily by California when additional state revenue is needed. As a result, federal legislation is needed to eliminate the states' ability to tax companies using the worldwide unitary method, both directly and indirectly (i.e., through use of an election fee).

III. WHAT SHOULD BE INCLUDED AS PART OF FEDERAL LEGISLATION

Even though a number of states have recently taken steps to repeal the worldwide unitary method and resolve the problem, the Chamber strongly contends that the ongoing dispute between the business community and the states over the unitary method will not be resolved totally and satisfactorily until federal legislation is enacted. There are two overriding tax policy reasons why federal legislation is needed to resolve the unitary issue:

(1) Unitary leads to the double taxation of income incorrectly apportioned to the state. The California legislation reduces but does not eliminate double taxation of foreign source income.

(2) Even though the current trend has been for states to repeal the worldwide unitary method in favor of the water's-edge method, federal legislation is needed to ensure that states will not seek to reinstate the worldwide unitary method in an attempt to raise revenue.

(3) Federal legislation is necessary to guarantee a free flow of international trade through all 50 states without the threat of a state impeding such movement of goods by employing the worldwide unitary method of taxation.

Under our constitutional system, the federal government establishes and carries out foreign policy. The regulation of international trade is an important element of that foreign policy. Chaos would result if each of the 50 states was able to establish, for example, its own tariff barriers and export regulations. The use of worldwide combined reporting by the states produces similar problems and prevents the federal government from being able to speak with one voice on behalf of the entire nation in conducting foreign policy.

The U.S. policy toward international trade has been to promote the free flow of goods and services across international boundaries. The United States has recognized that taxation can be an important factor in hindering or promoting international trade and has endeavored to make it a neutral factor. One of the most important aspects of that endeavor has been the prevention of double taxation through tax treaties and the foreign tax credit. The double taxation that often results from the use of worldwide combined reporting, however, runs directly contrary to those efforts.

The Chamber believes that certain critical elements must be included as part of federal legislation to resolve the worldwide unitary issue once and for all:

(1) States must be unequivocably prohibited from imposing income tax on any company by using the worldwide unitary method.

(2) States must be prohibited from including any portion of a corporation's foreign-source dividends as part of its income tax base.

(3) A water's-edge apportionment system must not include FSC's, DISC's, 80/20 companies and Subpart F income, since income from such sources is foreign source income and states should not tax foreign source income.

(4) Spreadsheet reporting requirements must be drafted so as to minimize the administrative burden on companies subject to the spreadsheet.

IV. TECHNICAL COMMENTS ON PENDING FEDERAL LEGISLATION (S. 1974)

As previously discussed, the Chamber strongly supports federal legislation to resolve conclusively the continuing worldwide unitary tax problem. Thus, the Chamber supports the overriding goals of S. 1974. It also contends that specific changes to the proposed legislation are needed to achieve a totally acceptable long-term solution to the worldwide unitary problem. The Chamber's proposed improvements to the bill are set forth below.

(A) Worldwide Unitary Taxation Should Be Unequivocably Repealed and Not Imposed as a Penalty for Noncompliance

The proposed legislation would prohibit the states from imposing the worldwide unitary method on any taxpayer with two exceptions. A state could continue to tax on a worldwide unitary basis if:

(1) A taxpayer materially fails to comply with either the new spreadsheet reporting requirements or with the legal or procedural requirements of state income tax laws; or (2) neither the taxpayer nor the government of the relevant foreign country provides material information to a state regarding the income transactions with certain related companies.

The prohibition on states' use of the worldwide unitary method must be unequivocal. Allowing the states to use the unitary method as a penalty for noncompliance with information reporting requirements is unwarranted. Due to the broad scope of the reporting requirements, it may be difficult for foreign companies and governments to provide U.S. taxing authorities with all the requested information. Instead, monetary penalties should be imposed to deal with noncompliance. Such monetary penalties are, indeed, the typical way in which the U.S. enforces the informational return requirements of its tax laws.

(B) No Portion of Foreign Source Dividends Should Be Taxed by the States

The proposed legislation would prohibit a state from taxing more than an equitable portion of a taxpayer's foreign-source dividends. A state shall not be considered to include in the income base more than an equitable portion of foreign-source dividends if the state:

(1) excludes from its income base at least 85 percent of such dividends;

(2) excludes from its income base the portion of the dividends that effectively bears no federal income tax after application of the federal tax credit; or

(3) adopts a method of taxation that results in an equitable apportionment of the dividends to the state substantially similar to (1) or (2), pursuant to regulations to be promulgated by the secretary.

No state should be permitted to tax any portion of foreign-source dividends. Even though foreign-source dividend income is included as part of a U.S. corporation's taxable income, federal law allows a foreign tax credit to be applied against U.S. tax for foreign taxes imposed on both the dividends and the corporate income out of which such dividends are paid. Dividends paid by a foreign corporation often are subject to a foreign tax greater than the combined federal and state rates in the U.S. In such a case, no federal income tax is imposed on the foreign-source dividends to avoid double taxation at the federal level. Double taxation at the state level results if the states do not follow the lead of the federal government and exempt such dividends from the tax base.

(C) The Threshold Level For Including 80/20 Companies As Part of the Water's-Edge Group Should Be Eliminated

Under the proposed legislation, states would be allowed to include as part of a water's-edge combination 80/20 companies with U.S. payroll, sales or purchases exceeding $10,000,000 in the companies most recent federal tax year. The Chamber believes that U.S. corporations with over 80 percent of their business activities outside the U.S. should be excluded from the water's-edge group without exception.

Such 80/20 companies are essentially foreign corporations, since their business activities occur primarily abroad. A U.S. corporation with mainly foreign operations should be treated the same as a similarly situated foreign incorporated business. The income from an 80/20 company related to its foreign operations is considered to be foreign-source; and for U.S. federal tax purposes, a foreign tax credit can be utilized to offset the foreign tax paid on such income to avoid double taxation. Since the U.S. federal tax structure treats this income outside the water's edge, the states should also exclude 80/20's from the water's-edge group.

(D) Information Reporting Requirements Need to Be Revised and Made Less Onerous

The Chamber is concerned about the administrative burden placed on companies subject to the reporting requirements in the proposed legislation. Those corporations required to file the domestic spreadsheet return include companies subject to tax in at least two states that own total assets with an aggregate original cost of at least $250,000,000, at least $10,000,000 of which are located in the U.S.

By defining reporting companies so broadly, many corporations that conduct little, if any, foreign activities would be subject to the domestic disclosure spreadsheet filing requirements. Furthermore, small businesses that annually export over $10,000,000 of goods the U.S. would also be subject to the reporting requirements.

The Chamber beleives that strictly domestic companies as well as companies conducting only minimal foreign business should be excluded from the definition of reporting companies. Since the reporting requirements are a tradeoff for the states abandoning the unitary method, it makes sense that only those corporations directly involved in the worldwide unitary dispute should be subject to the disclosure requirements.

Another area of specific concern to the Chamber is that the proposed legislation grants to the Secretary of the Treasury the discretion to prescribe information to be submitted by a reporting corporation beyond state income tax liability and method of allocation of income between the states, items which are specifically enumerated in the proposed legislation. The Chamber believes that such discretionary authority should be taken out of the hands of the Secretary of the Treasury. Only specifically identified items of importance to the states (i.e., state income tax liability and method of tax calculation and income allocation) should be made part of the domestic disclosure spreadsheet.

V. CONCLUSION

Continued use of the worldwide unitary method and the taxation of foreign-source dividends by certain states threatens the ability of the U.S. to adopt a coherent international trade policy and result in multiple taxation and overly burdensome compliance costs for businesses. The solution to the unitary problem must come at the federal level. As a result, the Chamber urges both the Senate and the House to immediately enact legislation that prohibits the use of the worldwide unitary combination method and the taxation by states of foreign source dividends.

STATEMENT OF THE BUSINESS REPRESENTATIVES OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HEARING ON S.1974 AND S.1113
SEPTEMBER 29, 1986

On September 23, 1983, then-Treasury Secretary Donald T. Regan announced President Reagan's decision to establish a Worldwide Unitary Taxation Working Group composed of representatives of the Federal Government, state governments, and the business community. According to the Treasury Department News Release announcing its formation, the Group, chaired by Secretary Regan, was "charged with producing recommendations...that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states." The membership of the Working Group was announced by Secretary Regan on October 28, 1983, and its first meeting was held on November 2, 1983.

At this first meeting, the Working Group established a staff or technical-level Task Force composed of representatives of the Working Group members to thoroughly review the issues and develop options for decision by the Working Group. From its inception through its final meeting on March 22, 1984, the Task Force held 145 hours of meetings on 20 separate days. At these meetings the Task Force heard testimony from numerous witnesses representing various federal, state, and foreign tax agencies, as well as business, labor, and public interest organizations, and academia. In addition, more than forty written statements from a diverse group of private witnesses and foreign governments were received and, along with the oral testimony, carefully analyzed with a view to developing a comprehensive solution to the unitary tax controversy. This all culminated in a report on options which was presented to the Working Group at its third and final meeting on May 1, 1984.

During the course of the discussions, domestic and foreign-based multinational corporations highlighted a number of specific problems they saw with the worldwide unitary method. They contended that this method of taxation leads to state taxation of foreign source income and is at variance with the internationally-accepted separate accounting method for avoiding double taxation. They also pointed out that to simply lump together income earned in numerous profit centers throughout the world and then divide the result on a three-factor (property, sales, payroll) formula basis automatically distorts the attribution of income to any particular source or state since in some centers losses are incurred, while others have actual profits, and neither profits nor losses are directly related to the ratio between the domestic and foreign factors. For example, an international wine producer based in France expanded its business by purchasing vineyards in California. These recent purchases of property had a relatively high cost basis. The company's old, established vineyards in France, however, had a comparatively low basis. The result, if the other factors remain the same, is an attribution of some portion of the wine producer's worldwide income to California simply as a result of the purchase of the high cost vineyards.

Many domestic multinationals also contended that distortion occurs because no deduction is allowed for foreign taxes or other payments to foreign governments. Also, the absence of a consistent and appropriate definition of a unitary business was cited as giving rise to an unacceptable degree of taxpayer uncertainty and possibly discouraging investment in the United States. Multinational corporations pointed out that although states justify the use of the worldwide unitary method on the basis of perceived profit shifting by multinationals, federal enforcement of separate accounting is adequate to protect against any misallocation or shifting of income. Foreign-based multinationals contended that use of the method imposed on them substantial administrative burdens because of the need to translate accounts of their entire foreign operations into U.S. currency and to conform them to U.S. and state accounting rules, which they would not have to do absent the requirements of the unitary method. Finally, both domestic and foreign-based multinationals pointed out that worldwide unitary has given rise to vigorous objections by numerous foreign governments which could very well lead to retaliatory actions.

In the "Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues, and Recommendations" which was issued by Secretary Regan on July 31, 1984, it was stated that the Working Group at its May 1 meeting had agreed that the following three principles should guide state taxation of the income of multinational corporations:

Principle One:	Water's edge unitary combination for both U.S. and foreign based companies.
Principle Two:	Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
Principle Three:	Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

The Chairman's Report went on to say that state and business representatives were unable to reach agreement on the proper definition of the water's edge, state tax treatment of foreign-source dividends and of U.S. incorporated corporations operating primarily abroad (so-called "80/20 corporations"). According to the Chairman's Report, these issues were left for resolution at the state level in accord with Principle Three above.

In the "Final Working Group Report" dated August 31, 1984, the statement by the business representatives first made the general point that, in their view, the three principles enunciated in the Chairman's Report form an indivisible package. That is, there is no business support of Principle Two (increased federal administrative assistance and filing of domestic disclosure spreadsheets), absent state support for Principles One and Three (an appropriate water's edge limitation; and competitive equality for domestic corporations and their foreign competitors).

The August 31 business statement then critiqued each Principle in turn. With respect to Principle One (water's edge unitary combination for both U.S. and foreign based companies), the key observations were the need for an acceptable definition of the "water's edge group", and that such definition not include foreign source income in the apportionable base. With regard to that basic assumption, it was pointed out that there were four items concerning foreign source income where business and the states were in disagreement: (1) Income of 80/20 companies; (2) the threshold of activity by a foreign corporation doing business in the U.S. which would subject it to state taxation; (3) the question of "tax havens" and their interaction and relation with water's edge groups; and (4) the treatment of foreign source dividends.

With respect to Principle Two (increased federal administrative assistance and filing of domestic disclosure spreadsheets), the business representatives reiterated that agreement and support on the part of business representatives was based on the understanding that the states would adopt an acceptable definition of the water's edge and also not tax foreign income in accordance with Principles One and Three.

As to Principle Three (competitive equality for domestic corporations and their foreign competitors), it was pointed out that any taxation of foreign source income of U.S. based multinationals adversely affects their ability to compete overseas with foreign based multinationals. The states must recognize that if states tax the foreign income of U.S. based multinationals, either by the use of the unitary method of taxation or by taxing foreign dividends, it necessarily results in a potentially non-competitive situation for U.S. based multinationals in both foreign and domestic markets, since they would be subjected to a higher combined tax burden than corporate groups which do business exclusively in the U.S. or exclusively abroad.

The August 31, 1984 business representatives statement concluded by expressing disappointment that the concerns described above, particularly state taxation of foreign source dividends, had not been resolved by the Working Group. The business representatives issued a call for a federal legislative solution if the states refused to adjust their taxing policies to eliminate the inherent distortion from the worldwide unitary method of taxation and thereby also ease the threat of retaliatory actions by concerned foreign nations.

At this point, it should be acknowledged that substantial progress has been made to date at the state level towards the complete elimination of the worldwide combined unitary method from the state tax scene. As of January 1, 1984, there were 12 states (Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah) using the worldwide combined unitary method of taxation. As of today, only three (Alaska, Montana and North Dakota) continue to use the method. However, some twenty-seven states continue to tax a certain portion of foreign source dividends, thereby indirectly continuing to double tax foreign source income. Others, though, have gone to a true water's edge system completely excluding foreign source income from the state tax base (e.g., Colorado, Florida and Idaho). Unfortunately, despite all this progress, the need for a federal legislative solution has not disappeared. Certain states continue to directly use the worldwide unitary tax method, one state requires the payment of a substantial annual fee as a condition of being relieved from the worldwide method, and other states indirectly impose their state tax on foreign source income. This discordant response sends a confusing policy signal to both foreign and domestic companies which may inhibit foreign investment in the U.S. and deprive domestic companies of the needed assurance that they will be permitted to compete in foreign markets without incurring state tax penalties.

S.1974 - Unitary Tax Repealer Act

S.1974 was introduced in the Senate on behalf of the ~~Administration~~ on December 18, 1985 by Senator Wilson (R-CA). The legislation would generally prohibit states from imposing income tax on any taxpayer on a worldwide unitary basis. However, a state would be permitted to allow taxpayers to elect to be taxed on a worldwide unitary basis. The bill also restricts the ability of states to tax foreign source dividends. Finally, the legislation would impose a number of new information reporting requirements regarding a taxpayers's aggregate state taxable income, allocation factors, tax payments, and stock investments in related companies (the so-called "domestic disclosure spreadsheet"). While superior to current law's total lack of restraint on state use of worldwide unitary taxation, S.1974 still has some problems which need to be addressed.

New section 7518(a) is not a complete prohibition against state use of the worldwide unitary method. States could still impose that method on taxpayers in two circumstances: (1) Where the taxpayer materially fails to comply with the requirements of the new domestic disclosure spreadsheet, or the legal or procedural requirements of state income tax laws; and (2) where neither the taxpayer nor a relevant foreign government provides requested information to the state. Imposition of the worldwide unitary method as a penalty for failure to follow an unrelated procedural requirement of state income tax laws is inappropriate.

The water's edge group (all of whose income can be permissibly included in the state tax base) as defined by the bill could, under certain circumstances, include 80/20 companies, foreign sales corporations, possessions corporations, and foreign corporations. The income of a foreign corporation would be included if it was subject to state income tax in any one state by virtue of business activity in that state and it has $10 million or more in U.S. property, payroll or third party sales (or purchases), or its aggregate average U.S. state tax factor is 20% or more.

Section 7518(c) also contains a definition of tax haven corporations (which are also included in the water's edge group) which goes beyond that suggested by the business representatives. Not only are foreign corporations engaged in no substantial economic activity classified as tax haven corporations, but foreign corporations that are engaged in substantial economic activity are so classified only because they are not subject to substantial foreign tax on net income and stated percentages of their sales or payments for expenses are to members of the controlled group.

New section 7518(b) does not require states to exclude from the income base any more than 85% of foreign source dividends, and could require exclusion of substantially less than 85%. It has been the consistent contention of the business representatives that inclusion of any portion of foreign source dividends in the state income base is an inappropriate extension of state taxing authority, leads to double taxation of the dividends, and constitutes a serious impediment to the competitiveness of domestic owned companies.

New section 6039A contains the requirements of the proposed domestic disclosure spreadsheet, and once again there are areas of concern. The new rules allow all states access to the spreadsheets, including states still using unitary. In addition, the Secretary is given authority to add to the information included in the spreadsheet, which seems inconsistent with the concept that the spreadsheet burden should be kept to a minimum. The section 6039A(a) requirement that corporations be listed in which the reporting corporation or its common owner have less than a controlling interest is unnecessary and burdensome.

Finally, the legislation also makes no provision for the exclusion from the spreadsheet of U.S. subsidiaries (other than section 501 exempt organizations) whose size or activities are such that states have not included them in income taxes calculated on a combined or consolidated basis. Elimination of such corporations from the spreadsheet was accepted by the Working Group, and authority for the Secretary to make such determinations should be included.

S.1113

S.1113 was introduced in the Senate on May 9, 1985 as part of the continuing effort by Senator Mathias (R-MD) to prohibit states from including foreign corporations in a "worldwide combination" to calculate a multinational corporation's taxable income. The bill accomplishes this result by prohibiting the states' from taxing an affiliates foreign source income until it is includable in the parent's gross income, and then only to the extent that the parent's aggregate foreign income tax rate is less than 46%. The bill does not, however, deal with the question of "tax havens" and their interaction and relation with water's edge groups or the threshold of activity by a foreign corporation doing business in the U.S. which would subject it to state taxation.

To calculate the amount of income the states can tax, the bill provides that once the foreign affiliate income is repatriated and is includable for purposes of chapter one, the amount to be taken into account may not exceed the lesser of (1) the actual amount of the dividend received, exclusive of any foreign income taxes or section 78 "gross-up"; or (2) a formula amount which is designed to take into account foreign taxes imposed on the dividend itself or on the income from which the dividend is paid. The formula is structured so that if the aggregate rate of foreign income taxes deemed paid by the U.S. corporation with respect to the dividends it receives from its foreign subsidiaries equals or exceeds the 46% federal income tax rate, no portion of the dividends received by the U.S. corporation from the foreign subsidiaries can be taxed by the various states. For these purposes, dividends from an 80/20 company are treated the same as dividends from a foreign corporation.

One of the major problems with S.1113 is that it would permit the states to include in their tax base foreign-source income. The bill's approach clearly fails to exclude the parent's foreign source operating income or income of 80/20 companies, and the potential for distortion from including affiliates' foreign source income is merely tempered at best by the proposed formula.

Another problem with the bill is its definition of "affiliated group". This definition provides that affiliated groups are comprised of a common parent and one or more chains of corporations connected through stock ownership with the parent. This language is quite similar to that contained in Code section 1563(a)(1). However, unlike the section 1563 definition which contains an 80% test for affiliation in the case of parent-subsidiary controlled groups, the S.1113 definition provides no ownership test at all. Additionally, unlike section 1563, S.1113 does not indicate how brother-sister controlled groups and combined groups should be treated. These omissions severely limit the protective scope of the bill.

Foreign Investment

The argument is sometimes made that if states are not allowed to tax any foreign source income it will merely encourage U.S. companies to invest abroad, and that if foreign investment were somehow made unattractive to U.S. companies, they would substitute investment in the U.S. for the foregone foreign investment.

This ignores several facts, however. First, the reasons why U.S. firms establish operations abroad are generally related to geographical location of natural resources or marketing requirements, and not tax purposes. If a foreign market can be served from a U.S. plant, it will be so served through exporting. However, all too frequently obstacles are placed in the way of exporting such as restrictive import duties, requirements that a percentage of the product be manufactured locally, on-site inspection requirements, governmental procurement practices and other regulatory provisions. To overcome such obstacles and to compete effectively for foreign markets, it often becomes necessary for the U.S. producer to manufacture on-site in the foreign market area. Since he cannot serve that market by exports from the U.S., his only alternative to establishing a facility abroad would be to leave the market to foreign owned competitors.

Second, it must be recognized that direct foreign investment by U.S. companies is in any event a powerful stimulus to the U.S. economy in a multitude of interrelated ways. Jobs for American workers are created directly through actual employment of U.S. workers by the foreign subsidiaries, and indirectly through purchases by the foreign subsidiaries of equipment and supplies manufactured in the U.S. by U.S. workers. Dividends remitted by the foreign subsidiaries to their U.S. parent corporations are used for new U.S. consumption and investment.

Finally, not making the foreign investment does not assure an alternative investment in the U.S. Companies invest in U.S. plant and equipment where the anticipated, risk-adjusted after-tax returns exceed the expected financial costs. Making foreign investment less competitive and less profitable because more heavily taxed than foreign based competitors does not make domestic investment more profitable. Indeed, the more likely result is a negative effect on the purchase of domestic goods and services to help U.S. managers operate abroad.

Conclusion

For domestic multinationals to compete abroad, total taxes cannot be higher than those of their foreign competitors. To compete domestically in any given state, total taxes cannot be significantly higher than those of their purely domestic competitors. The key, therefore, is that states refrain from including foreign source income of a domestic multinational corporation in the state tax base.

Thus, we urge the Congress to take up the invitation extended many times by the Supreme Court [e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); Container Corp. of America v. California Franchise Tax Board 463 U.S. 159 (1983)] and provide a federal legislative solution to the unitary controversy. As the Supreme Court has stated, in Foreign Commerce Clause cases the need for national uniformity is essential and Congress has the power to preempt state laws to attain that uniformity and prevent the states from creating competitive disadvantages among similarly situated entities. Either S.1974 or S.1113, as modified per our comments described above, would be a good start toward finally ending the worldwide unitary tax controversy and creating the national uniformity and competitive equality now so sorely lacking.

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